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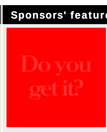

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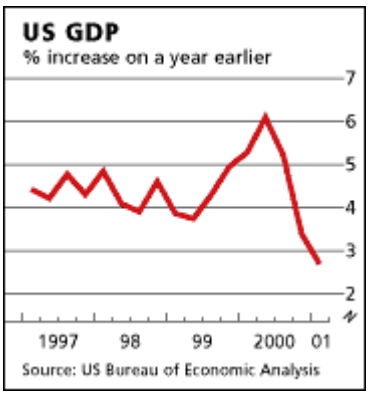
Business this week

May 3rd 2001
From The Economist print edition

America grows

America's GDP grew at an annual rate of 2% in the first quarter, twice as fast as expected. But growth for the 12 months to the end of March slowed to 2.7%, the lowest year-on-year growth since the first quarter of 1996.



See article: America's still-troubling economy

Car sales in the United States fell by 11% in April, compared with a year earlier, as the economic slowdown trumped the willingness of manufacturers to maintain sales by discounting prices.

Ecuador dropped its opposition to the agreement reached between America and the European Commission to end their long-running **banana dispute**. The commission agreed to grant substantial preferences to imports of Ecuador's bananas during the EU's transition to a quota-free market.

Three cases began at the European Court of Justice concerning the use of "golden shares" by EU member governments to veto **cross-border takeovers** of formerly state-owned firms.

Germany's government is reportedly ready to back out of talks on a **European takeover directive** that has been 12 years in the making. The Germans fear that making it harder for managers to create "poison pills", a device that is meant to deter hostile bidders by reducing the value of a company after an offer, would make it too easy for foreigners to acquire German companies.

Hanging up

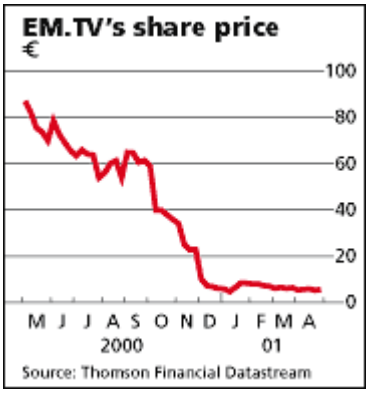
British Telecom chipped away at its £30 billion ($43 billion) debt mountain by agreeing to sell its 20% stake in **Japan Telecom** and its 20% holding of **J-Phone**, a mobile subsidiary, to **Vodafone** for ¥652 billion ($5.3 billion). Vodafone acquired a further 10% from AT&T for $1.35 billion, increasing its holdings in Japan Telecom to 45% and in J-Phone to 46%. Vodafone's largesse extended to helping BT get out of Spain as well as Japan; it bought BT's 17.8% stake in **Airtel** for £1.1 billion.

See article: 3G mobile-phone woes

Vodafone raised £3.5 billion ($5.1 billion) in a quick-fire share placement to help finance its clutch of recent acquisitions. The markets are now braced for an even bigger rights issue by **British Telecom**.

EM.TV, a struggling German media group, announced losses for last year of DM2.8 billion ($1.6 billion), far higher than had been expected. To shore up its ailing finances, the company plans to sell the Jim Henson Company, creator of the Muppets, and, as part of an earlier rescue package, will transfer 20% of its 37.5% stake in Formula One motor racing to Kirch, another German media group. EM.TV interpreted losing these sources of revenue—for which it had greatly overpaid—as "a clear signal for a new beginning".

See article: Up fast, down fast for EM.TV



Disharmony

Objections by European regulators brought discord to a proposed merger between **EMI**, a British music group, and **BMG**, owned by Germany's Bertelsmann. EMI had attempted to team up with AOL Time Warner's Warner Music last year, but the same concerns, about an industry dominated by four big players rather than five, persuaded the competition watchdogs to block that deal.

See article: EMI and Bertelsmann part ways

AOL Time Warner began talks with **NTL**, Britain's biggest cable operator, about a possible broadband distribution deal in Europe. AOL Time Warner lacks a European distribution network but has content aplenty with which to entice NTL, which has 8.5m European subscribers.

General Electric's planned $40 billion takeover of **Honeywell** was cleared by American antitrust authorities. But the deal is still being scrutinised by the European Commission.

Reuters, a business-information group, bid £190m ($272m) for part of Bridge Information Systems, enhancing Reuters' own transaction services and trading technologies. Bridge, which is in Chapter 11 bankruptcy, accepted the offer, subject to confirmation by the bankruptcy courts.

Microsoft admitted that its new XP operating software, a marriage of its home and business Windows operating system, would be delayed. A June launch date is now out of the question; August or even next year has been suggested as more likely.

The eponymous founders of **Lernout & Hauspie**, a Belgian speech-recognition software company, together with a former vice-chairman of the firm, were arrested and charged with false accounting and manipulating the company's share price. Once called Belgium's "Microsoft", L&H said that it would try to sell assets to pay off its prodigious debts, though the company could go bankrupt first.

Going, going, gone?

America's Justice Department said that it would indict a former head of **Christie's**, Sir Anthony Tennant, and the former head of **Sotheby's**, Alfred Taubman, for an "international conspiracy" lasting six years to fix commission rates. The world's two leading auction houses have already agreed to pay out some $512m in compensation to clients in connection with a civil suit alleging price-fixing.

Nomura, a Japanese investment bank, offered **Compass Group**, a catering company, £1.85 billion ($2.65 billion) for its international hotel chain, **Le Méridien**. The bid exceeded a previous offer from Marriott, an American hotel chain, but still falls short of the $2 billion-plus that Compass had hoped to raise.

Dow Chemical said that it would shed around 4,500 employees to help cut costs by more than $1 billion, as it completes a takeover of Union Carbide, a former rival, in a bad period for the chemicals industry. Union Carbide's former staff are likely to bear the brunt of the cuts.

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The world this week

May 3rd 2001
From The Economist print edition

Missile defence

President George Bush announced plans for an ambitious **anti-missile system** to protect the United States and its allies from missile attack. He also promised cuts in America's nuclear arsenal.

See article: George Bush's arms-control revolution

The **Pentagon** suspended all military ties with China, and then, hours later, revoked the decision, claiming a misunderstanding. Ties will be reviewed on a case-by-case basis.

Congress provisionally agreed on a **$1.35 trillion tax cut** spread over 11 years. The deal came after Mr Bush agreed to compromise on his plan to cut taxes by $1.6 trillion over ten years.

See article: A tax-cut deal gets closer

Louis Freeh, the director of the **FBI**, who frequently clashed with the Clinton administration, resigned, despite being asked by Mr Bush to stay on until his ten-year term ends in 2003.

Reuters

Mr Bush set up a 16-member commission to look at Social Security reform. Democrats moaned that it was stacked with people keen to privatise the pensions system.

Vice-President Dick Cheney rejected a request from Pope John Paul II for clemency for **Timothy McVeigh**, who is due to be executed on May 16th for the Oklahoma City bombing.

Domingo Cavallo, **Argentina**'s economy minister, tried to banish fears of a debt default. He announced tax increases and spending cuts aimed at meeting a target for the fiscal deficit approved by the IMF. The Fund applauded, and said it would speed up aid, if needed.

See article: Economic struggles in Argentina

Mexico's **Zapatist** movement said it would continue its rebellion, after Congress had approved a watered-down version of a law to promote Indian rights. The government urged the Zapatists to talk, but itself criticised the weakening of the law.

See article: A setback for Mexico's Indians

The European Union offered aid to **Colombia**, to support peace talks with guerrillas and to provide alternatives to drugs. Together with other donors, it promised *euro*330m ($294m).

In **Ecuador**, opponents of a VAT increase demanded by the IMF failed to muster enough votes in Congress to cancel it.

Berber anger

More than 60 people died in riots in Kabylia, **Algeria**'s Berber heartland. The riots were triggered by the killing of a teenager in custody, but reflected the anger of young Algerians at the lack of jobs and houses.

President Abdelaziz Bouteflika promised an inquiry, but one Berber-based party resigned from the government and the other called for peaceful protest.

See article: Berber riots in Algeria

Shimon Peres, Israel's foreign minister, went to Cairo and Washington, DC, to discuss an Egyptian-Jordanian plan for an **Israeli-Palestinian truce**. But the violence continued. Eight Palestinians and one Israeli were killed. Israeli tanks destroyed buildings in a Gaza refugee camp. Ariel Sharon warned of tough new measures if the Palestinians continued their mortar fire.

See article: The Sharon-Peres bond

Zambia's ruling Movement for Multiparty Democracy voted to change the constitution to allow President Frederick Chiluba to run for a third term in office. In defiance of a court order, the party also voted to expel Vice-President Christon Tembo and eight ministers who opposed the change.

See article: Zambia's president tries to stay on

In **Zimbabwe**, President Robert Mugabe's "war veterans" switched their attention from white-owned farms to private businesses, occupying premises of companies and demanding compensation for workers that had been laid off during the past three years of recession. In a pastoral letter, the country's Roman Catholic bishops sharply rebuked the government for the political violence.

The International Rescue Committee, an American aid agency, estimated that 2.5m people had died from malaria, diarrhoea and violence in **Congo** since the start of the war in August 1998. Angered by a United Nations report accusing both Uganda and Rwanda of widespread looting of Congo's minerals, President Yoweri Museveni said he would pull out of the Lusaka peace process.

See article: Congo's president gains status

Asian troubles

A "state of rebellion" was declared by the **Philippine** government after thousands of supporters of ex-President Joseph Estrada demonstrated against his arrest on corruption charges. In violent clashes in Manila, three protesters and a policeman died.

EPA

See article: Rebellion in the Philippines

After a second vote of censure in parliament, Abdurrahman Wahid, the winner 18 months ago of **Indonesia**'s first contested presidential election, seemed close to impeachment.

See article: The growing threat to Wahid

A delegation from the EU had talks with the **North Korean** leader, Kim Jong Il, in Pyongyang, designed to ease tensions in the Korean peninsula. America has suspended talks with North Korea started by the Clinton administration.

See article: Europe's North Korean diplomacy

Anwar Ibrahim, Malaysia's former deputy prime minister, sentenced to 15 years in jail for corruption and other crimes, was refused permission to travel to Germany for an operation on his spine.

A plan for Europe

A document written under the aegis of Gerhard Schröder, **Germany**'s Social Democratic chancellor, proposed a more federal system for running the European Union. The European Commission and the European Parliament would both be strengthened, while the Council of Ministers, where representatives

of EU governments currently take most big decisions, would become an upper chamber of the European Parliament.

See article: Gerhard Schröder's vision for Europe

Ethnic-Albanian guerrillas killed eight members of **Macedonia**'s security forces in the most violent incident since unrest started in that country two months ago.

See article: Albanians v Slavs in Macedonia

Many Orthodox priests protested against a day-long visit to **Greece** by Pope John Paul II. He was set to make the trip on May 4th.

See article: Pope John Paul goes to Syria

Reuters

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Bush's nuclear umbrella

May 3rd 2001
From The Economist print edition

DO NOT underestimate the scale of the arms-control revolution that America's president, George Bush, plotted out in public this week. For 30 years the two mainstays of nuclear-armed stability between the United States and Russia—still, despite the rise of China, the most potent nuclear powers—have been a meticulously monitored balance between their respective arsenals of bombs and missiles and the renunciation of an effective anti-missile shield, since the side that thought it had the better protection might be tempted to attack the other in the belief that it was safe from counter-attack. This carefully preserved "balance of terror" is what first gave these once implacable cold-war foes the confidence to start cutting their nuclear stockpiles. Now all that is to be swept aside (see article).

The aim, Mr Bush insists, is still a secure world with the lowest possible number of nuclear arms "consistent with our national security needs, including our obligations to our allies". But he calculates that this is now best achieved by unilateral cuts, not long-winded weapons talks with Russia, and by scrapping the Anti-Ballistic Missile (ABM) treaty, so as to build new defences for America and its allies, not against Russia or China, but against less predictable, albeit limited, missile threats from places such as Iraq, Iran or North Korea.

To many a committed arms-controller, it is as if Mr Bush had dropped a nuclear bomb on their world, reducing the familiar landscape of treaties and agreements—he opposes the ratification of the test-ban treaty too—to rubble. Yet, more than a decade after the cold war ended, America is right to take a radical look at how security and stability can best be ensured in a very different world.

There is no point, for example, in clinging nostalgically to the ABM treaty as the "cornerstone" of strategic stability for the past 30 years, if clinging to it in this form stops America—and Russia, no longer a sworn enemy and itself interested in some sorts of missile defence—from dealing with new missile threats. Similarly, why preserve an arms-cutting process that has cut not a single extra bomber or missile for a decade?

But in being radical it is also important to be right. Among Mr Bush's advisers are some who are as ideologically committed to scrapping treaties as others are ideologically committed to preserving them. Yet his new plans need to be judged by the same practical, non-ideological standard as past arms-control agreements: do they produce greater stability and security? Or are they, as critics on both sides of the Atlantic claim, merely an effort to bolster America's defences at others' expense, and likely to leave everyone worse off?

At first, the United States' pursuit of missile defences caused offence all round. But sceptical Europeans now acknowledge the threat: some regime bent on bother might (mis)calculate that attacking New York or Los Angeles, or indeed London or Berlin, could make aggression pay. Even Russia and China, whose technology sales to dubious regimes lowered the entry barriers to the long-range missile business in the first place, have agreed to talk.

But the practical, stability-preserving, tests of Mr Bush's missile-defence plans are yet to come. Will such defences work? Recent tests of land-based systems have failed, though new variants—still derided by opponents as "faith-based"—may well do better without the constraints of the ABM treaty.

Are even the "limited" defences being talked of affordable? Mr Bush has yet to spell out his plans. But if the billions to be poured into new defences come at the expense of the proper modernisation and reorganisation of America's conventional forces, then he will simply have made the world a bit safer for more conventional sorts of violence. His recent attempt to cut funds for programmes designed to stem the leakage of know-how and bomb-making materials from Russia's nuclear complex to help make way for his tax cut will not reassure critics that he has his security priorities right.

Even if new defences can be made to work, America still has good reason to proceed with caution. Not least, since technology seldom works flawlessly and there are plenty of other ways of delivering a nuclear, chemical or bug bomb, any future defences have to work in ways that strengthen deterrence and diplomacy—the traditional means of dealing with threats to peace—not undermine them. Hence the need to try to replace the ABM treaty's outdated elements with new understandings that Russia and others can live with. And hence the final test of missile defences: can they be deployed without provoking a wider arms race?

The best, and worst, of worlds

Mr Bush is clearly hoping that his promised deep cuts in America's nuclear arms will serve to reassure his allies, and also Russia and China, that his arms-control revolution can bring big benefits. Despite a series of Start agreements on strategic arms cuts, both America and Russia have many more weapons than they need. Getting rid of a lot of them makes sense. Unilateral cuts can certainly be made more swiftly, but they come at a price. Out, along with the laborious hours of negotiation, will also go the meticulous rules for checking that each side is keeping its word. That mattered a lot between enemies. Does it still matter between sort-of-friends?

Frankly, it does. Russia has recently shown itself all too ready to break the rules: witness its recent sale of nuclear fuel to India, deliberately breaking a clear and long-standing anti-proliferation promise. In the 1990s, America and Russia agreed separately that they would withdraw a lot of tactical nuclear weapons; America did, Russia did not. The only way of getting rid of Russia's surplus nuclear warheads safely—something that was to have been agreed upon in a Start-3 treaty—is under the beady eye of America with the law behind it.

What is more, the openness that comes with agreed checks on the nuclear balance between America and Russia reassures others too. The hope has been gradually to draw China, the most secretive of the nuclear set, into more serious arms-control talks—possibly discussing a rough trade-off between the size of its growing arsenal and the scope of America's future defences. But if America and Russia are no longer swapping weapons details, China is unlikely to start.

It is possible that America and Russia can strike a new and reassuring bargain that avoids a destabilising row between them. It is certainly too early to say that they will not. But the diplomacy, as well as the technology, must be got right. At a time when Mr Bush proposes to "move beyond" the ABM treaty, and not to ratify the test-ban treaty—another way of checking what both the nuclear powers and the nuclear aspirants are up to—a failure of diplomacy would risk achieving the worst of all worlds: one in which suspicion and rivalry, not security and stability, were the name of the game.

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Banana politics in the Philippines

May 3rd 2001
From The Economist print edition

Swept into the presidency undemocratically, Gloria Macapagal Arroyo is hanging on to it in the same fashion

AP

CHAOS and bloodshed at the gates of the presidential palace. Leading senators arrested. A ban on rallies by the opposition. A "state of rebellion" declared. That was the Philippines this week, doing a very passable imitation of a banana republic—for the second time this year.

The first time was in January, when Joseph Estrada was ousted as president by a combination of mass demonstrations, the defection of most of his cabinet and the intervention of the army's chief of staff, who transferred his loyalty to Mr Estrada's vice-president, Gloria Macapagal Arroyo. At the time, many people in the Philippines thought this was excellent. Mr Estrada had been a bad president, using his office to line his own pockets and those of his many mistresses, some of whom were provided with houses of a lavishness incompatible with an unpadded presidential salary.

When Congress turned against him and sent him for trial before the Senate, Mr Estrada rallied his supporters there, who voted to suppress the evidence against him, sending the outraged middle-classes out on to the streets. Though the official line is that Mr Estrada voluntarily left the presidency—which he denies—Mrs Arroyo's more honest supporters argue instead that the system had clearly failed, and the greater good was served by bending a few of the rules.

But there is a heavy price to be paid for extra-constitutional activity. As Filipinos ought to know better than most, it is all too easy to acquire a taste for removing presidents the non-democratic way: after the original "people power" revolution of 1986, Cory Aquino had to endure a long series of attempted coups during her unfortunate presidency. Stability returned only with the administration of Fidel Ramos, a former army chief.

What Mrs Arroyo appears to have overlooked is that her predecessor—elected, it should be remembered, by a landslide vote in 1998—remains very popular among most of those who put him in power: the poor. A former movie star who specialised in playing Robin-Hood-like gangsters, Mr Estrada—"Erap" to his fans—stood for the little guy against the rich and powerful. The Philippines remains one of the world's most polarised countries. Unlike most of eastern Asia, it has never enacted land reform: a dozen families, with which Mrs Arroyo herself has many connections, control well over half the country's land.

Those supporters, who already feel that Mr Estrada was robbed of the presidency by the plutocracy, have been incensed by the treatment meted out to him since then. Allowing television cameras in to film Erap being fingerprinted, photographed and confined to a common criminal's cell may have been legal and even just, but it was not intelligent.

Always with her, and growing angrier

It would be reassuring to believe that this week's "rebellion" will prove unique, and that Mrs Arroyo is now fully in control. That is certainly what the financial markets in Manila seemed to think: the main stock-exchange index jumped 4% after she showed her willingness to use the iron fist. But the reality is that Mr Estrada's supporters are not about to go away. If they were angry before, they will be doubly angry now. And Mrs Arroyo shows clear signs of abusing her position. The senators she has locked up without warrants on suspicion of involvement in the "rebellion" just happen to be the ones campaigning against her in the election due on May 14th. And her attempt to secure majorities in the two houses of Congress will hardly be hindered by her bans on all rallies in central Manila, which looks to be aimed at

the opposition. “Philippine democracy is now in its death throes,” said one of Mrs Arroyo’s opponents this week. She had a point.

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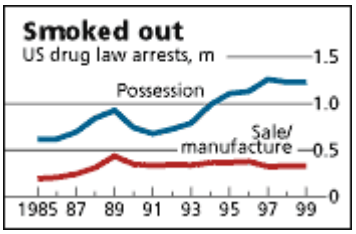
Experiment with drugs, Mr Bush

May 3rd 2001
From The Economist print edition

America's drugs policies don't work. Alas, the Bush administration seems to want more of the same



BY ANY reasonable measure, America's "war on drugs" is a disaster. At home, ferocious "mandatory sentencing" laws are the main reason for the country's huge prison population. Almost one in four of the country's 2m prisoners are there for drug offences, with only a limited chance of becoming productive members of society when they are released (see article). Abroad, America is being sucked into domestic conflicts, notably in Colombia; and recently its forces shot down a "drugs" plane in Peru that turned out to be carrying missionaries. Meanwhile, drugs have never been easier to get in the United States, with prices lower, purity higher and experimentation among schoolchildren as rampant as ever.

The Economist has long argued that drugs should be decriminalised. Few politicians will go that far, but many have edged in that direction. Back in January, George Bush, who was once busted for drink-driving and has always danced around the question of whether he took drugs in his misspent youth, seemed to be one of them. He argued that long minimum sentences for first-time drug users were not the best way "to occupy jail-space". He also worried about the disparities between the sentences handed down for possessing crack and those for powdered cocaine—disparities that help explain why so many more blacks go to prison than whites.

The distant hope that a pragmatic conservative might yet change policy in a way that a liberal Democrat might not dare have now been dashed. First, Mr Bush announced that he would enforce a law that will deprive drug offenders of federal grants or loans for college education (one of the better ways of getting them back on the straight and narrow). Now the White House is strongly hinting that it will appoint John Walters as the new drugs "tsar".

Mr Walters is to the drugs war what first world war generals were to trench warfare. He does not lack experience (he was a deputy drug tsar under Mr Bush's father), but his basic reaction to the heavy losses sustained so far seems to be merely to increase the size of the attack. Mr Clinton's drug policy, in his view, was too soft. The idea that American sentences are too harsh is "among the great urban myths of our time". He points out that only 8.8% of those in state prisons are there for possession (which is true, but ignores the fact that many of the 11.3% who are there for drug-trafficking are there for being little more than lowly mules in the production process). Another "urban myth" is the idea that the "criminal justice system is unjustly punishing young black men."

In policy terms, Mr Walters opposes the idea of distributing syringes to drug addicts as a way of controlling the spread of HIV. He dislikes even the thought of limited legalisation and various sorts of treatment. "If anything," he wrote recently, "the trend of anti-drinking and anti-smoking efforts today is to criminalise certain aspects of use and to attack availability."

It would be hard for Mr Bush to claim that he had no choice other than to be a hardliner. Voters have passed eight state ballots calling for marijuana to be legalised for medical purposes since 1996; Californians have also voted for an initiative requiring treatment instead of incarceration for a person's first two drug offences. Tommy Thompson, Mr Bush's secretary for health and human services, and several prominent Republican governors, have suggested that America should rethink its drugs policy. The shooting down of the aircraft in Peru, which killed an American missionary and her baby (and may have delayed Mr Walters's appointment), has served as a powerful reminder to Americans of the cost of the overseas drug war.

Of course, Mr Walters may change his views once he is in office. But a policy of increased repression will surely result in thousands of people being thrown in prison for sins that are little worse than those alleged of the youthful George Bush: being young and irresponsible. An older and more responsible Mr Bush should reconsider his choice.

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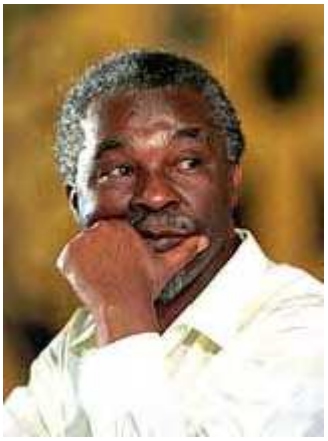
Mbeki loses the plot

May 3rd 2001
From The Economist print edition

And South Africa finds it has a paranoid president

AP



WHAT ails Thabo Mbeki? Few would have expected that South Africa's president, who is regarded even by his critics as a clever man, would lose the plot, yet even fewer can believe that a genuine plot to overthrow Mr Mbeki, is or was, afoot. Last week South Africa's safety and security minister, Steve Tshwete, said the police were investigating a conspiracy against the president, and named three well-known politicians-turned-businessmen of being behind it. Mr Mbeki himself spoke of a conspiracy. But no serious evidence of anything remotely like a coup has been revealed. Does it all mean that Mr Mbeki is going off the rails?

The suggestion has been made before, when Mr Mbeki—who presides over a country with more AIDS cases than any other—was questioning whether HIV infection caused the disease, and was dabbling with other, bizarre theories. But Mr Mbeki is not barmy, merely paranoid. That, at least, seems the most likely explanation of the conspiracy episode. How comforting that should be to South Africans is another matter.

It is not altogether surprising that Mr Mbeki should think others might want his job. Aloof, slightly introverted and all too obviously lacking the magnetism of his predecessor, Nelson Mandela, he is not a hugely popular politician. Moreover, he has few successes to trumpet for his two years as president: despite his government's sound macroeconomic management, growth remains slow and jobs elusive. But even if this were not so, rivals would still be eyeing his job; ambition, after all, is the stuff of politics. Yet no one except Mr Tshwete, and presumably his master, despite some backtracking, seems to believe that any of the three named "conspirators"—Cyril Ramaphosa, Tokyo Sexwale and Mathews Phosa—has really been involved in the kind of conspiracy that should properly be investigated by the police. None other than Mr Mandela has come to their defence. The "plot" seems to be a farce.

The mirthless consequences

It is a damaging one for Mr Mbeki, for three reasons. First, it draws attention to the divisions within the ruling African National Congress (ANC). These are inevitable, because in South Africa it is within the ANC that the usual activities of an opposition are played out: the ANC is likely to remain in power for as far ahead as anyone can see, and therefore provides the only plausible way to high office. Moreover, as a movement, not a party, it has no ideological glue; all that holds its parts together is a history of shared opposition to apartheid and the realisation that if it does not disintegrate it can hang on to power for years, even decades. Within the ANC's ranks, therefore, left-wingers and trade unionists constantly rub up against thorough-going capitalists. Even more abrasive perhaps are the relations between those who spent most of their lives outside South Africa during the long years of apartheid, who include Mr Mbeki and most of those around him, and those who remained at home, either in prison or leading strikes and other protests. Mr Ramaphosa was one such.

Second, the incident draws attention to Mr Mbeki's own shortcomings—and just as he seemed to be putting some damaging mistakes behind him. Last year he earned much criticism for his cranky attitude to AIDS, his reluctance to criticise the violent despotism of Robert Mugabe in Zimbabwe and his racially divisive speeches at home. Recently, however, he has held his peace about AIDS—though it remains unclear whether he will allow the treatment of AIDS patients now that his government has won from foreign pharmaceutical companies the right to cheaper versions of their drugs; he has openly criticised Mr Mugabe's thuggish "war veterans" in Zimbabwe; and last week—post-"plot"—he celebrated South Africa's Freedom Day with a speech that was a model of racial conciliation. All this suggests a welcome sensitivity to criticism. But the "plot" has brought back the doubts.

With them, inevitably, come doubts about political stability. This worry, the third unwelcome consequence of the episode, is misplaced: a coup or other violent sorts of opposition look highly unlikely. But South Africa needs more than stability. It needs the promise of prosperity and harmony, both to ensure that its most educated citizens stay at home and to lure investment from abroad. South Africa's very proximity to Zimbabwe and Zambia, where events go from bad to worse (Zambia's president wants to defy the constitution by seeking a third term, see article), make it all the more important that the conduct of affairs should go smoothly in what is still, despite everything, an African success story. Having a paranoid president does not help.

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Schröder's Europe

May 3rd 2001
From The Economist print edition

Not all bad, but the German chancellor's bold opening shot may have misfired

AP

GERMANY'S chancellor, Gerhard Schröder, is right to take the lead in the great debate about the European Union's constitutional future (see article). He is right to single out as the EU's worst feature its failure to win the loyalty or interest of its citizens. He is right to demand a clearer division of the EU's powers. He is right, and bold, to suggest a repatriation of much of agricultural and regional policy to the countries that make up the Union. He is right, too, to declare that the EU must sharpen up its ways of collective decision-making as it expands from its present membership of 15 to as many as 27. The new intake may start as early as 2004, when a new constitutional arrangement for the EU, if not a new constitution, should, according to the treaty signed in Nice last December, be ready. And he is right not to be coy about asserting Germany's weight. There is just one unfortunate aspect to Mr Schröder's party document, which was leaked over the weekend: a lot of it is cock-eyed.

This is not because it is as self-serving as it is visionary. As the draft of a document due for approval at a party conference this autumn, it is certainly meant to please German voters, many of whom remain glum at the prospect of losing their beloved D-mark notes next year and resent their country's long-standing role as the Union's main cash cow. Mr Schröder's plan, for instance, to repatriate much of farm policy to the EU's members would make Germany much better off. And giving more power, as he wants, to the European Parliament would bolster the country most strongly represented in that body by virtue of its population—namely Germany.

Moreover, much of Mr Schröder's vision would replicate, on a wider scale, Germany's own federal system. In particular, he seeks to reassure Germany's 16 *Länder*, or states, which are prickly in defence of their considerable powers, that they will not be constitutionally submerged in a wider Europe. The idea of turning Europe's Council of Ministers, where the most important collective decisions are now taken, into an upper chamber of the European Parliament, likewise seeks to mimic Germany's own Bundesrat, the upper legislative chamber in which the *Länder* are represented.

In any event, non-German Europeans should not be frightened by the sight of Germany taking the lead in Europe. Under the rubric of a European Germany rather than a German Europe, Mr Schröder and his party strategists are perfectly entitled to try to mould Europe in their country's own image. It is true that the balance of power within the club, indeed its geographical centre of gravity, is already changing—to Germany's gain and France's loss. And it is striking that France has so far contributed little to the debate on a new constitutional arrangement for the EU; its prime minister, Lionel Jospin, has been deafeningly silent, though his minister for Europe has been quick to rubbish the German plan. But that need not cause Mr Schröder to stay quiet. However the EU is reshaped, there will be enough checks to ensure that Germany cannot ride roughshod over its partners.

Better the council route

Where Mr Schröder goes wrong is in his advocacy of a stronger parliament in Strasbourg and a stronger commission in Brussels. His aim—to make Europe's citizens feel more involved—is admirable. Secretive though it is, the present Council of Ministers has more legitimacy than the European Parliament because it is made up of representatives of national governments—with which most Europeans still most strongly identify. Downgrading it would take the EU further from ordinary Europeans, not closer to them. Hoping that new institutions will bind them together and so help create a new European "demos" is putting the cart before the horse. Indeed, it could cause more rancour than harmony.

Where Mr Schröder is right is that Europe does need a proper constitution to simplify its tangle of treaties, to make the workings of the club understandable to ordinary citizens, and to define the Union's

limits. The debate should start at once so that the 15 governments could gather in a constituent assembly in, say, a year's time, to write the sort of constitution that *The Economist* itself suggested last October. Then, by 2004, new members from the east could start joining a club that works better. It already reflects poorly on European democracy that the euro was launched after such scant consultation among the people affected. With a much bigger Union in prospect, a new constitutional deal must be hammered out democratically and put to national referendums if the EU is to shed its image of a remote, bureaucratic monster.

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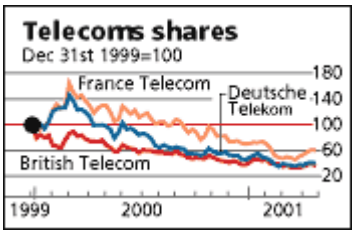
The telecoms begging bowl

May 3rd 2001
From The Economist print edition

Europe's mobile-phone companies may have overpaid for their third-generation licences, but governments should be careful about changing the terms

Get article background



ANYONE who has been to an auction knows how it happens. The object, seen from afar, looks delectable. The temptation to outbid the next chap is irresistible. Then the hammer falls. You find that you got carried away, the object was not what you wanted, and you can't really afford it. The inclination is to blame the auctioneer, not your own bad judgment. That, roughly, is what Europe's telephone companies are doing. Finding that they have agreed to pay Europe's governments some $125 billion for licences to operate third-generation (3G) mobile-telephone networks, some have begun to wriggle. Governments should keep their nerve.

In Britain, Gordon Brown, the chancellor, has rightly rejected companies' suggestions that they should get a refund. But in Germany, the companies are hoping to save the huge cost of building separate networks by altering the terms of the original auction. The government is giving this idea more attention than it deserves.

There are good reasons for the companies' misery. They have borrowed heavily to buy their licences; and new technical problems have emerged (see article). Meanwhile, customers' lukewarm response to Europe's Internet-enabled WAP phones has made some sceptics question just how much they will be willing to pay for 3G services.

So should governments soften the terms? The most seductive argument is that it might benefit consumers. Faced with huge costs, the argument goes, companies will be unable to develop their networks quickly, depriving people of the chance to use this new technology. But this is unconvincing: if consumers were so eager to get their hands on 3G telephones, there would be a premium for getting to market first. Another argument is that, if governments do not help the former telecoms monopolies out of their financial mess, they might go bust, depriving people of telephone service. But that looks highly unlikely—and even if a fixed-line company did go under, it would be simple to find a replacement operator.

More persuasive are some of the arguments for network sharing. The case seems stronger with 3G networks, because they will require between four and 16 times as many base stations to achieve the same coverage as existing (2G) services. Sharing would reduce the ugly proliferation of masts across the countryside. It would also save money. Estimates by Analysys, a British consultancy, suggest that a new entrant could save up to 19% of capital costs by sharing the main costs of base stations and equipment.

Hold the line

Consumers might indeed have gained had governments decided to create a single network company, and to allow service providers to pay to use its infrastructure. New services might then have come to market faster and more cheaply.

However, it has proved hard to ensure that competitors gain access to the existing fixed-line monopoly network on reasonable terms. A monopoly network owner that shares infrastructure with competitors has every interest in charging its rivals as much as it can. For 3G networks, the regulator's job would have been even harder. Several companies would probably have had incomplete networks. Each would play host to its rivals in some areas, and rent out their networks in others. No company would have much interest in keeping prices down—and the consumer would have lost. There is an even bigger problem with both network-sharing and refunds: they change the rules of the auctions retrospectively. This is

unfair to those who dropped out of the bidding. Had they known they would not have to meet the full costs of their bids, they might have stayed in. It is unfair to consumers too: different winners might have been better winners.

Then there is the possible effect on future auctions. Governments have rarely sold public property this way before, but they should be keen to hold more auctions. If they now flinch, they are, in effect, telling future bidders that, if they “overpay”, they will not have to worry. That has two drawbacks. First, it teaches companies that it pays to lobby, and ensures that they divert resources from running their business well into the unproductive but lucrative business of badgering politicians. Second, it creates an incentive to overbid in future. If the telecoms companies really overbid this time, it is all the more important not to change the rules *ex post.*

The real cause of the companies’ troubles is that the market has changed. They did their sums before they made their bids. They knew the risks. Who else knows what the market is worth? Hans Snook, former head of Orange, one of the British licence-buyers, said only last week: “In a few years, people will think that the prices we paid were conservative.” Governments should not second-guess such an authority.

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Letters

May 3rd 2001
From The Economist print edition

The Economist, 25 St James's Street, London SW1A 1HG
FAX: 020 7839 2968 E-MAIL: letters@economist.com

Silvio Berlusconi

SIR—You fail to understand why so many Italians want Silvio Berlusconi as prime minister ("Fit to run Italy?", April 28th). They hope that as a businessman he will bring change to Italian society by pushing its culture closer to that of English-speaking democracies.

Italy has never been a true democracy by British standards. Fascism was replaced by a democratically elected oligarchy inspired by a social-catholic ideology which hampered reform. The communists only weakly opposed this as they were even less interested in turning Italy into a modern capitalist democracy. The oligarchy put its placemen in all key posts in the civil service and the state-controlled parts of the economy.

Mr Berlusconi is the only leading politician who can speed up change and beat the corrupt domination of the older established parties. It was he who realised that Italians were fed up with living in grey multi-storey buildings. It was he who was first to satisfy the popular demand for new media outlets not controlled by the oligarchy. New ideas imported by Mr Berlusconi into Italy extend to many other areas. Indeed, he has already profoundly changed Italy. If successful he will show that a country can be better run by a talented CEO than by a professional politician. If Mr Berlusconi fails, Italians will give him the sack.

ALFONSO CECCHERINI-NELLI
Reading, Berkshire

SIR—Mr Berlusconi is probably no saint but at least his ideas, programmes for our country's future and personal history reflect free enterprise, liberalism, devolution of powers to local government, deregulation, civil rights, separation of powers and the rule of law. Mr Berlusconi may be a liar and a thief, and he may not do what he promises if he is elected, but at least he has a plan of which millions of Italians approve.

P. ROSSI
Florence

SIR—At least, as the world's 14th-richest man, Mr Berlusconi does not need to steal public money.

GIANMARCO TUCCINI
Rome

Blunkett's targets

SIR—Your leader on targets itself misses the point ("Missing the point", April 28th). The reduction of primary school class size did not lead to an increase in secondary school class size. Class sizes in all age groups rose up to 1998. When infant class size fell, it was as a result of targeting extra teachers and classrooms on those schools. Secondary pupil-teacher ratios actually rose at a much slower rate than previously, despite an extra 190,000 pupils because of increased funding. This year saw the first fall in ratios for more than ten years.

You say that children became more literate and numerate with primary school targets "at the cost of squeezing out other beneficial activities such as sport." Standards did improve with better teaching and more time devoted to English and maths. Since we reduced the curriculum in other subjects—and

increased after-school provision for sports—we were well prepared.

The truth is that targets have worked most effectively in raising the game of schools, pupils and education authorities that were lagging behind most. Targets are accompanied by greater transparency but simply providing information and resources without developing clear goals will do little for public-service reform.

DAVID BLUNKETT, MP
Secretary of state for education and employment
London

Making-up the grade

SIR—Professors who give a poor grade may find that the student files a complaint charging discrimination, retaliation for refusing sexual favours or simple unfairness (Lexington, April 14th). Once a complaint is filed, the professor usually has to undergo a prolonged accusatory process to defend the grade. Professors, particularly if non-tenured, cannot be certain that the complaint-review board, department head, or dean will back them. The same applies to professors who report students who cheat. The safer course for a professor is not to incur the risk.

MARSHALL RAFFEL
Philadelphia

SIR—The practice of hiring many adjunct teachers with tenuous job security puts pressure on such teachers to grade students highly in order to get glowing reports on teacher-evaluation forms. This is often the only feedback a school administration has when making hiring decisions. As an adjunct teacher, I have experienced criticism from a department head, who, having read a particularly poor student's negative assessment of me, implied it was my teaching that was at fault. We must not upset the "customers".

WILLIAM WATSON
Chicago

SIR—Lexington overlooks an obvious culprit behind grade inflation. Since the beginning of the 1960s, especially at bastions of privilege like Harvard, incompetent scions of powerful families (like George Bush) have found it harder and harder to gain admittance. Many have been replaced by hard-working working-class whites and minorities. In short, the students got better.

JAMES LANDRY
Chicago

SIR—The "circumstantial evidence" that Lexington cites is wrong. Grade inflation did not follow the introduction of affirmative action; rather, its origins may be found in the Vietnam war. Professors helped students avoid the draft by keeping them in college.

NOAH STOFFMAN
New York

Gender benders

MADAM—You argue that women should not be insulted by the use of "he" and "his" as the gender might be unrelated to sex ("Third person singular", April 14th). Half of the world, we women, are so pleased that you are not biased. In the same edition of your newspaper, I counted 58 male photos and drawings and only eight female ones. Are images of people with penises unrelated to sex too? And all these years I thought you were under-representing women. Please cancel my subscription.

SANDRA BERMUDEZ
New York

SIR—We have already accepted "Ms" as a neutral form of "Miss" and "Mrs". So let us replace "he" or "she" with "ze". His or her becomes "zer". Him or her becomes "zim". I bet we would get used to it in a couple months if *The Economist* started doing it.

STEVE GELLER
El Cerrito, California

SIR—English is ever ready to generate a new word as need arises. Why not consider the logical—ie, neological—solution?

> Creativity unleash,
> Wedding “he” with “she” in “heesh”.
> Mutate freely, paste and scissor,
> Coupling “his” and “her” in “hiser”.
> Fertilising egg with sperm,
> Marry “her” to “him” in “herm”.

RICHARD GOODYEAR
Washington, DC

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Economist.com SPECIAL

George Bush's revolution

May 3rd 2001 | WASHINGTON, DC
From The Economist print edition

This week, the president outlined his new strategy for America's defences. The world may have trouble getting used to it

BACK in the "Ban the Bomb" 1960s, when the United States and the Soviet Union were churning out ever more missiles and warheads, people assumed that by the turn of the century there might be 20 countries, or more, in possession of nuclear weapons. It did not happen. A series of hard-won arms-control and non-proliferation agreements held the line at five, including Britain, France and China. (Israel, coyly, still refuses to confirm or deny that it has nuclear capability.) In 1998 India blasted through the line, followed swiftly by Pakistan. Even then, post-cold-war thinking still held that nuclear weapons, though destined for a long half-life, were losing their political potency. Some day, they might even be negotiated into oblivion.

Now radicals are in full voice again: but this time from America's right, not the disarming left. Deep cuts in nuclear arms are high on their agenda, but done in ways that will make a disarmer's hair stand on end. President George Bush this week repeated his vow to take a radical, even revolutionary, look at America's security needs. His strategy has two parts: arms cuts, unilateral if necessary, and missile defences to help fend off smaller, less predictable new threats from countries such as North Korea, Iran or Iraq. Many of America's allies in Europe, as well as more traditional arms-controllers on both sides of the Atlantic, fear this policy may well provoke a new, and wider, arms race.

Mr Bush argues that he must deal with a different world from the immediate post-cold-war one. The picture changed in 1998, when North Korea tested a surprisingly sophisticated rocket that galvanised the debate in America about missile defences. At the same time, illicitly-acquired weapons technologies have been slowly seeping to unstable regions such as Asia, the Gulf and the Middle East. North Korea, Russia and China appear increasingly to be helping Pakistan, Iran, Syria, Libya and others to make missiles. Once learned, the secret of how to deliver a nuclear bomb by fast-flying missile—like the secret of how to build a bomb in the first place—is not going to be unlearned again.

Mr Bush's predecessor, Bill Clinton, was aware of these threats but deliberately dragged his feet, preferring to rely on diplomacy and deterrence. Meanwhile, detailed arms-control talks with Russia proceeded at a snail's pace. Mr Bush, impatient with this, says he will take his own view of America's nuclear requirements. He will make unilateral cuts in weaponry where it is safe to do so, and will take some remaining weapons off high alert.

No one doubts that traditional arms control has stalled: there has been no new arms-cutting treaty between America and Russia since the 1993 Start-2 agreement, which has yet to be implemented. Both countries have far more long-range nuclear weapons than they need. But with Russia signalling a readiness for deep cuts too, is this the moment to scrap the whole process?

Along with proposing these cuts, Mr Bush is an enthusiastic explorer of missile defences. This alarms those who have long regarded the 1972 Anti-Ballistic Missile (ABM) treaty with Russia as the cornerstone of strategic stability. Since the ABM treaty bans national missile defences, it seems clear that, if Mr Bush gets his way, the treaty's days are numbered.

Mr Bush denies any intention of sparking another arms race with Russia, China or anybody else. He has described his policy as "a search for security, not a search for advantage". Yet his rejection of classic

arms control and set-piece treaties, of the sort laboured over by diplomats for the past 30 years, unnerves Europeans in particular. They worry that it will lead all too easily to suspicions and rivalries among the big powers, and heightened danger for the world at large.

What is more, treaties already signed now seem in danger of unravelling. In 1999, when the Senate refused to ratify the Comprehensive Test-Ban Treaty, arms-controllers consoled themselves with the thought that at least the Clinton administration still strongly supported it. Mr Bush, however, says he does not, although his aides insist he has no plans to resume nuclear testing. There is now no prospect that America will lean on others to sign the treaty—it will not even press India, which may soon be tempted to test again. Yet a test ban was part of the deal in 1995 that won the indefinite extension of the Nuclear Non-Proliferation Treaty (NPT), which commits most of the world's governments to forswear nuclear weapons. So there is growing concern that the NPT itself could be put at risk.

From offence to defence

To many, it seems that America is now seeking its own security at the expense of others. Mr Bush's officials deny it. They say that classic arms control, founded on the assumption that the greatest threat to strategic stability was the prospect of a nuclear war between America and the Soviet Union, has simply outlived its usefulness. "Russia is not quite France, but neither is it an adversary," says one. Instead, say Mr Bush's men, new thinking is required to take account of new threats, including terrorism, and of the new means available to deal with them.

Such ideas have penetrated further in America than in Europe, although the Europeans have started to listen to America. A recent report by the Commission on National Security, a bipartisan group set up by Congress, concluded that "a direct attack against American citizens on American soil is likely over the next quarter-century." Similarly, Donald Rumsfeld, America's secretary of defence, argued recently that, although the United States was safer from the threat of massive nuclear war than at any time since the dawn of the nuclear age, "we are more vulnerable now to the suitcase bomb, the cyber-terrorist, the raw and random violence of an outlaw regime or a rogue nation armed with nuclear missiles and weapons of mass destruction." Missile defences, Mr Bush's officials admit, cannot cope with all these potential threats. But if traditional arms-control and anti-proliferation efforts have broken down, such defences may be an effective part of the response.

Some missile-defence boosters outside the administration, egged on by the military-industrial complex, go much further, arguing that the whole strategic landscape is shifting. The old, deliberately scary, notion that nuclear war was best prevented by mutual vulnerability to nuclear attack—known in the jargon as mutual assured destruction, or MAD—is on its way out. The primacy of offence, they argue, should now give way to the primacy of defence.

Insiders admit that this is going too far. It would be folly for any country to rely solely on anti-missile defences for protection. Technology, after all, seldom works flawlessly. Besides, as Mr Rumsfeld and other senior Bush officials acknowledge, there are many other threats to security, of which ballistic missiles, though potent, are only one. Defences against them are part of an insurance policy, not a first resort.

That said, defences seem bound to play a bigger role in the future than they have in the past. They may be regional—helping, say, to defend forces deployed to some trouble spot in Asia, or to protect the Middle East against missile attack—or they may be more extensive, shielding America's cities and, Mr Bush insists, those of its allies too. But, as in any revolution, there are huge uncertainties.

The first is the most basic: can missile defences be made to work? Several tests of the land-based interceptors proposed by Mr Clinton proved embarrassing failures. America has also been prevented from developing other systems by the requirements of the ABM treaty. There is a lot of work still to do. Second, what sort of defences will Mr Bush pursue—land-based, sea-based, air-based, space-based, or some combination of all these? Certainly, attempting to place weapons, as opposed to sensors, in space would make it virtually impossible to trade limits on defensive weapons for limits on offensive ones among the bigger powers, since the opportunities for suddenly overturning agreed limits on space-based systems would be almost as limitless as space itself.

Lastly, can any future defences be made to fit some continuing arms-control and anti-proliferation framework? Or will they simply lead to a new race in the weapons—whether nuclear, chemical, or tipped with viruses—they are meant to defend against?

The shape of shields to come

Mr Bush's aides are well aware that these defences are still in their infancy, and that none of the necessary technologies has yet been shown to work. Thus when he sketches out his plans in more detail, before he meets his European counterparts in NATO and the European Union in June, Mr Bush will be picking out the kinds of defences he intends to pursue, not what he knows for certain he can deploy. Even a two-term President Bush may well have left office before central elements of the defences now on the drawing board can be fielded with any confidence.

But although the finished architecture has yet to come, Mr Bush is likely to propose more robust defences than Mr Clinton's clutch of ground-based interceptors, radars and sensors. Senior officials use the terms "limited" and "light", both of which, if true, will reassure America's still-nervous allies and may help to placate the Russians and (at a bigger stretch) the Chinese. But the planned defences are also likely to be layered to counter missiles at different stages in their flight-paths, and to include both a "small" land-based component and sea-based defences that can deal with some missile threats closer to their source. And although space-based lasers are still many years away, the intermittent research of the past two decades seems likely to continue.

What is more, even if Mr Bush stays true to his word—trying to block the still-limited threat from roguish regimes, rather than the strategic deterrent forces of either Russia or China—the ABM treaty, at least in its present form, is for the scrap-heap. Its current provisions, though they allow some strategic defences and exempt more limited regional ones, strictly curb national missile defences based on land. They also rule out sea-, air- and space-based ones, and would prevent the sharing of technology with allies. These may all be part of Mr Bush's plans.

To some people, such as Senator Jesse Helms, the treaty has long been void and should be junked. The Soviet Union, after all, no longer exists. Senior administration folk take a slightly more diplomatic view: it seems absurd, they say, to keep such a treaty, signed to codify the principle of mutual assured destruction with an implacable ideological enemy, as the "defining principle" of relations with a very different Russia. And they argue that the ABM treaty did not bring the deep cuts in offensive weapons that were promised. It seems folly to cling to a treaty that, in the words of one official, "is stopping us having a good relationship with Russia".

American officials dislike being asked if they plan to "violate" or "tear up" the treaty. They point out that it has provisions both for revision (it has been revised several times already) and, if necessary, for abrogation. Those in Mr Bush's team who worry about the diplomatic repercussions in Europe and beyond—and it has to be said that some worry more than others—would clearly prefer to replace the treaty with a new set of understandings with Russia. Might Russia agree to that?

A lot depends on how Mr Bush handles things. An early, seemingly gratuitous abrogation of the treaty as a point of principle, as some Republicans have suggested, would provoke sharp retaliation. A period of genuine consultation, like the one America has started with its European allies, could capitalise on Russia's interest in working jointly on some technologies. Russia has now conceded that there is a missile threat to be countered. Its own proposed solution—mobile anti-missile units offering very limited protection to bits of Europe and none to the United States—is considered a non-starter even in Europe, not just in the White House. But Russia has opened the bidding, and the effort has been noted.

The end of Start

Will Mr Bush's arms-cutting plans help or hinder a missile-defence deal with Russia? Russia's Duma has long said it will pull out of all Start agreements on strategic nuclear reductions if America abandons the ABM treaty. But Russian officials have hinted in the past at a possible price for reaching a new set of "understandings": America's agreement that they can keep some multi-warhead missiles of the sort that were supposed to be scrapped under Start-2. At this point, more traditional arms-controllers tear their hair; such missiles are too potent, ideally suited for a surprise strike, and thus destabilising to the overall strategic balance. But Mr Bush's officials are not ruling out such a deal.

In part, this is because Start-2 looks dead anyway. That agreement, as well as scrapping multi-warhead missiles, would have cut both sides' arsenals to around 3,000-3,500 apiece, down from 6,500 under Start-1. But Mr Bush prefers to make unilateral cuts. Since this is so, the Start-3 talks look doomed too. These would have cut deployed warheads to around 2,500 on each side and, for the first time, destroyed

excess warheads as well as their launchers.

So does the Bush revolution mark the end of arms control? Not at all, say administration officials. They insist that their review of nuclear-weapons strategy, like that of missile defences, will be “fundamental”, not the “cold-war lite” of the Clinton years. Mr Clinton’s approach left much of America’s targeting strategy intact, and thus encouraged military chiefs to resist deep weapons cuts. Some Bush people talk speculatively of heading well below Start-3 levels, even with China’s still expanding, if smaller, arsenal to contend with.

The Start process itself, however, has a dim future. Almost the only thing Mr Bush’s officials feel could usefully be salvaged from it are Start-1’s provisions for verification and openness. These could be used to monitor missile-defence-friendly limits on Russia’s multi-warhead missiles, and—assuming Russia does not abandon this treaty too in a fit of pique at whatever America decides to do with the ABM treaty—to keep track of what Mr Bush’s officials hope could yet be “reciprocal unilateral cuts” by both America and Russia. The two sides could then codify what they had achieved. And if Russia refuses to go along with that? “So be it,” comes the nonchalant reply.

It is possible that two such radical notions—limited missile defences and swifter, but unilateral, arms cuts—can be made to mesh in ways that avoid a big row with Russia. It is harder to assess their effect on nuclear proliferation, the problem that first sparked the determination to rethink America’s strategic defences.

Although both Russia and China have recently signalled a readiness to talk to America about missile defences, both say they remain deeply hostile to them. Earlier this year, Russia’s then defence minister, Marshal Igor Sergeyev, accused America of a “desire to achieve strategic domination of the world”. China recently accused America of “unilateral nuclear expansion”. Unlike Russia, China is just as opposed to less powerful regional missile defences, since it fears these could be used some day to protect Taiwan against its own missile force. If either Russia or China were to react to Mr Bush’s plans by deploying lots more nuclear weapons in an attempt to overwhelm his defences, others such as India, no doubt followed by Pakistan, might follow suit.

A new arms race?

Similarly, even a “limited” anti-missile shield that relied on space-based sensors could provoke the speedier development of anti-satellite weapons and thus an arms race in space. Shortly before he became Mr Bush’s defence secretary, Mr Rumsfeld chaired a commission that concluded that space warfare was virtually inevitable. To “negate the hostile use of space” against it, the commission said, America would need to be able to project power “in, from and through space”—a challenge neither Russia nor China is likely to ignore.

Back on earth, arms cuts announced by one side can add to uncertainty if there is no means to check that what is promised is done. America is still trying to work out what Russia did with the tactical nuclear weapons it said it was withdrawing in the early 1990s. Verification has value for others too. The Start agreements helped China know what the bigger powers were up to. Germany and Japan, who have renounced nuclear weapons and are dependent on America’s nuclear protection, could be confident that a balance would hold. By contrast, Mr Bush’s rejection of the test-ban treaty makes it harder to know who is up to no good.

Mr Bush’s stratagems for stemming the proliferation of nuclear, chemical and biological weapons and the missiles that carry them are less developed than his plans for anti-missile defences and for arms cuts. That leads some to worry that he has given up the cause. His aides deny this, claiming their approach to proliferation will be more “focused” and effective. Signals so far are mixed.

America is leading the drive to try to change the sanctions imposed on Iraq, tightening those on military imports and on the revenue from secret oil sales that Saddam Hussein can use to buy equipment and expertise for his illicit weapons programmes. Similarly, although Mr Bush will probably continue to explore a potential deal with North Korea to end that country’s production and export of longish-range missiles, he is likely to insist on tougher checks that any deal is holding. And he is expected to press Russia and China to curb the flow of missile and other technologies to Iran, Pakistan and other countries.

But the new “focus” can blur. An example was Mr Bush’s early effort, in pursuit of his promised large tax cut, to chop some of the Co-operative Threat Reduction programmes that attempt to stem any leakage of

materials and expertise from Russia's sprawling nuclear complex. It was Congress that insisted that the money for the programmes should not be cut. Meanwhile, Indian officials are confident that Mr Bush will lift the few sanctions that remain in the wake of their 1998 nuclear tests. Were America to go a step further, offering India help to make its weapons safer, it would probably break its own NPT promises.

Such selective application of the rules—indulging friendly India while checking North Korea or Iran—would offend those who believe that the only way to ensure respect for the NPT, and for other international weapons-limitation agreements, is to draw firm lines against proliferation. Here, too, Mr Bush has some hard selling to do. The arms-control revolution he proposes—missile defences, unilateral arms cuts, selective anti-proliferation policies—is already causing plenty of consternation in its broad outlines. But America's friends, as well as its enemies, also know that the devil will lie in the details.

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Coming to a neighbourhood near you

May 3rd 2001 | NEW YORK
From The Economist print edition

A small hitch with America's policy of imprisoning more people than any other country on the planet: most have to be released at some point

Get article background

JOSE VASQUEZ has a scar on his right cheek and a conviction for accidental manslaughter. Arrested at the age of 16, he was convicted as an adult and locked up for seven years in an upstate New York prison. He should have been released earlier, but the prison authorities dished out "disciplinary sanctions" for a series of fights. At first that meant solitary confinement; then, for several months, being locked in his cell for 23 hours a day. The parole board twice put off his release. Now Mr Vasquez is 25 years old, has been free for two years, but must do at least two more years of parole. Still, he counts himself "pretty fortunate".

He was lucky because prison, eventually, turned his life around. "Prison made me realise I made a mistake, it really moulded me." Inside, he passed a high-school exam, then a college degree. In solitary confinement he read "poetry, novels, spy stories, a lot of stuff, some Freud," and started to write. After a couple of years of casual jobs, he now works at the Osborne Association, a New York group that helps ex-inmates to find jobs and homes. Last year it placed 1,162 ex-prisoners with local employers—not bad, considering that its average client is 33 years old, has only a sixth-grade education and has done four years behind bars.

Few are as lucky as Mr Vasquez. Each year, hundreds of thousands of people leave America's prisons, but only a few thousand get help from groups such as Osborne. Most are ill-prepared for life outside, educated in little else but how to commit crimes more efficiently. Outside his job, Mr Vasquez unsurprisingly avoids cellmates who might lead him into "shady ways".

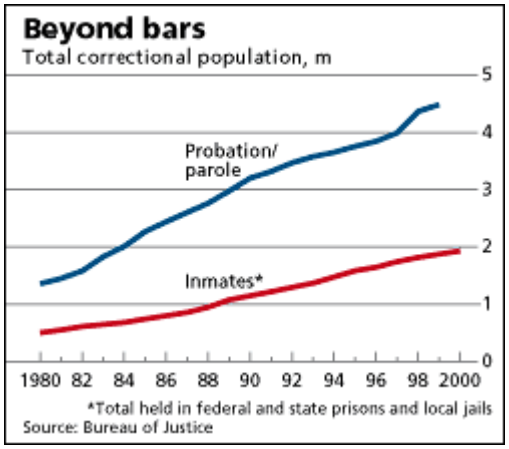
States seem to put far more effort into locking up people than trying to reform them. In New York, Governor George Pataki has made a point of cutting prisoners' education and other services. Today, Mr Vasquez would be unable to "mould himself" with a college degree in prison. And, although vastly more criminals are jailed for drug offences than in the past, many states have cut efforts to rehabilitate inmates. The number of inmates in drug programmes dropped from 201,000 in 1993 to 99,000 in 1998.

As the economy turns down, jobs will be harder to get; and there is an ever-rising number of ex-prisoners chasing them. An estimated 614,000 people will leave prison this year, says the Bureau of Justice, compared with 423,800 in 1990 and 156,400 in 1980. In all, there are now nearly 4.5m people on probation (served instead of detention) or on parole (served after detention).

This army of ex-cons is the final, perhaps unforeseen, stage of the country's love affair with mandatory sentencing. Ever since the mid-1980s, politicians have won votes by promising to get tough with criminals. The most prominent effect has been in the law courts: limiting the discretion of judges to make the punishment fit the crime, and imposing harsh minimum terms. Between 1986 and 1997, average prison sentences (in federal prisons) increased from 39 months to 54 months.

California's "three strikes" rule, which enforced a prison sentence for anybody caught committing a third felony (no matter how small), drove more into prison. Punishments for drug offences have been particularly severe. Drug-dealers can expect five-year or ten-year terms if caught. And the definition of drug-dealing is a harsh one, sweeping in spouses of dealers, whose crime may be simply failing to shop their husbands. Drug convictions are the reason for the massive growth in prison numbers.

Once behind bars, inmates find it increasingly difficult to get out early. Parole boards are stricter than ever, quickly returning criminals to complete their sentences if, for example, they are found to be taking drugs. And, since prisoners are less likely than before to get time off for good behaviour, they have less incentive to behave well.



The result: America's prison population has boomed, to roughly 2m. One person in 142 is behind bars, up from one in 218 a decade ago. America not only has more people in prison than anywhere else, but a higher incarceration rate (it recently passed Russia). It now spends $40 billion a year, roughly $20,000 per prisoner, on keeping offenders behind bars.

What is the effect of having so many people passing through the prison system? Some argue that prison has helped to reduce the country's crime rate, which has been dropping steadily for a decade, by as much as 8% a year. James Wilson, a criminologist at the University of California in Los Angeles, points out that the median number of offences committed each year by those going to jug is now 12.

Others, such as Alfred Blumstein, a professor at Carnegie Mellon, say that locking people up only partly explains the drop in crime. The rest is accounted for by changing economic fortunes, by shifting demography (when there are fewer young people, there is less crime), and by new fashions in drug abuse (crack cocaine is out of vogue, so the violence associated with its sale has declined).

Either way, with more people leaving prison, there are more ex-convicts in society. Just as enthusiasts for tough sentences once sought to tie the prison population to lower crime rates, now opponents argue that it is spells in prison that are helping to increase criminal behaviour. Recidivism rates have not changed for decades, but there are far more ex-convicts: roughly two-thirds of the ex-cons are likely to be rearrested within three years, and 40% will probably go back behind bars.

This debate will rumble on—not least because it is impossible to prove the deterrent effect of tougher sentences. But two things are happening. First, the crime rate has begun to edge up again in some places. In all, crime dropped by only 0.3% last year, much less than in recent years. In bigger cities, such as New York and Los Angeles, violent crimes such as murder (which tend to lead the way for other crime trends) are beginning to rise again. Some of that may be explained by a demographic bulge in young people, but it could also be explained by the large number of ex-cons in society.

Second, in a delayed reaction to the generally lower crime rates of the past decade, the prison population is beginning to peak. Having risen on average by 5.6% for the past decade, last year it grew by only 2.3%, the lowest annual increase since 1971. In several states, including New York and Massachusetts, the number of people coming out of prison already exceeds the number going in.

How this will affect public opinion remains to be seen. For most of the past decade, Americans have believed (wrongly) that the crime rate has been rising. They have generally supported building more prisons, partly because this brings jobs, but also because of their punitive effect. The reintroduction of chain-gangs, or dressing inmates in pink uniforms and giving them mind-numbing work, are all popular.

In a new book on prisons, "Going up the River: Travels in a Prison Nation" (Random House), Joseph Hallinan cites surveys showing that, 30 years ago, most Americans saw the purpose of prison as rehabilitation. Now they say it is punishment. Among the fruits of that policy are the bulging penitentiaries across the country—and the flood of ex-cons now hitting the streets.

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A tax cut beckons

May 3rd 2001 | WASHINGTON, DC
From The Economist print edition

HALF a loaf is better than no loaf at all—particularly when the half is more like four-fifths and the loaf in question is worth $1.6 trillion. On May 1st, Republican and Democratic leaders hammered out a compromise over the budget that clears the way for a $1.35 trillion tax cut over the next 11 years. The agreement is still non-binding: Congress gets down to the nitty-gritty in the summer. But it gives the strongest indication yet of the shape of the final budget.

EPA

Two track mind

George Bush had to compromise over both the size and the timing of the tax cut. Lobbying senators for his original package of $1.6 trillion over ten years until the last moment, he encountered stiff resistance from a centrist block of 14 Democrats and two Republicans. He accepted a Democrat-inspired stimulus package of $100 billion in immediate tax refunds and rebates to help pep up the economy. (The president's plan called for a gradual introduction of tax cuts over five years.) And he will almost certainly have to compromise a bit over expenditure, with spending increases likely to exceed Mr Bush's 4% target by a point or two.

But this represents a significant victory for the president. A $1.35 trillion tax cut would be the biggest in two decades, more than double the $500 billion chop proposed by Al Gore. It would probably also contain several right-wing shibboleths, such as a doubling of the child tax credit, relief from the marriage penalty and repeal of the estate tax.

The odds are much more heavily stacked against tax-cutting today than they were two decades ago. Ronald Reagan rode into office on the back of a huge tax revolt having won the presidency overwhelmingly. Mr Bush embraced tax cuts for internal party reasons—the hard right never forgave his father for breaking his "no new taxes" pledge—and struggles with the fact that most voters, when asked what they want to do with the surplus, say they do not want taxes to be cut.

Two Bush qualities have been to the fore. The first is his shameless opportunism. He has seized on every stray bit of economic news, from worries about giant budget surpluses to fears of imminent recession, as evidence that America needs a tax cut. He risked talking down the economy for the sake of his number-one priority. The second quality is his relentless focus on a small number of big issues. For a lazy frat boy who had everything handed to him on a plate, Mr Bush has decent powers of self-discipline.

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Public transport

Bus tussle

May 3rd 2001 | LAS VEGAS
From The Economist print edition

PASSING two big diesel engines, up on blocks for a service, the depot manager nods approvingly. “Good warhorses”, he calls them. At ATC/Vancom’s depot on the northern side of Las Vegas, reliability is esteemed. This private bus firm, which has operated Citizens Area Transit in Las Vegas since 1993, has cut costs, increased the number of passengers on the city’s buses threefold, and added new routes beyond the Strip. Drivers even carry their own tool kits for doing repairs on the road.

EPA

One day their bus will come

Cities expect such flexibility and efficiency when they turn the operation of public transport over to private firms. These benefits can come, however, at the expense of drivers and other workers, who find their wages cut to save money. A recent book* by Jonathan Richmond, a transport expert, argues that politicians too often see only one side of the equation.

Las Vegas had an unusually peaceful transition to a single private transport firm, since it never had a public system. In Denver, by contrast, the experience was rough. In 1988 a Republican state senator set out to cut 40% of the operating costs of regional transport with a bill to privatise the entire system. State Democrats, prompted by unions fearful for their members’ wages, leapt to oppose the bill. The outcome was privatisation of an arbitrary 20% of the system, increased a few years later to 35%.

Drivers’ wages in Denver have fallen so steeply, as a result of firms competing for bids, that the bus firms now find it hard to attract and retain good workers. ATC, which is also a contractor in Denver, has an employee turnover there of 170% a year. One firm won a contract with a notoriously low bid, only to leave a few months after starting operations because it could not find enough reliable drivers at the wages it was offering.

In Los Angeles, state Democrats have helped preserve the bloated public Metropolitan Transportation Authority (MTA) from privatisation. One large chunk of the region’s transport was carved off from the MTA with the creation in 1989 of the Foothill Transit zone, covering much of the eastern part of the city. Again, local conservative politicians pushed it through. The result has been better service but, again, lower wages and higher turnover among drivers.

The unions have now worked on politicians to resist any more inroads into the MTA’s territory. Democratic legislators in Sacramento, the state capital, drafted a bill in 1999 that blocked the expansion of Foothill and the planned creation of a new zone in the San Fernando Valley, which covers much of northern Los Angeles. Gray Davis, the governor of California, vetoed the bill. But last year MTA workers went on strike, and the unions assured the governor that the strike would end once the bill passed; so Mr Davis signed a new version in September.

Just west of the MTA’s territory, in Santa Monica, another public-transport authority offers an example of good service without the enmity of unions. It runs buses at roughly the same hourly cost as in the private Foothill zone, but gives its drivers comparable pay and benefits to those in the MTA. Santa Monica, suggests Mr Richmond, shows that smaller operations are the model.

Defenders of the MTA reply that Santa Monica, a middle-class beach town, offers less of a challenge than central Los Angeles. But splitting the monolithic MTA into a series of smaller operating divisions with autonomous management would allow more innovation. One hopeful sign for Los Angeles is that John Catoe, the director of transport services in Santa Monica, is a strong contender to become the next head of the MTA when the job comes up later this year. The decision will be in the hands of the new mayor of

Los Angeles, who is to be elected on June 5th. Both candidates are Democrats; but, if they can swerve from their party line on the single subject of buses, their constituents may thank them for it.

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* "The Private Provision of Public Transport". A. Alfred Taubman Centre for State & Local Government, Harvard University, 2001.

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Lexington

The Kerrey affair

May 3rd 2001
From The Economist print edition

“IT IS well that war is so terrible, else we should grow too fond of it.” The words of Robert E. Lee stand as the best comment not only on Bob Kerrey, the former presidential candidate accused of having committed a war crime 30 years ago, but of a more recent policy: that of handing over suspected war criminals to tribunals. As America anguishes over the revelations, the idea of drawing a solid line between what is permissible and unacceptable in war looks ever harder to do. Meanwhile, Lee’s words also contain a warning: that dreadful as one bloody night in Vietnam now appears, it at least forces combatants and the public to confront the moral horrors of war in ways that may become impossible with the warfare of long-distance aerial bombardment.

The basic facts of the Kerrey affair are shocking enough to divide America, even without the presence of a man who has been seen as a war hero. On the night of February 25th 1969, Mr Kerrey led a team of navy SEALS to Thanh Phong, a village on the Mekong delta, where they believed Vietcong guerrillas were meeting. At a hut on the outskirts, they found five people and executed them to prevent them jeopardising the mission. Mr Kerrey claims the victims were men. Gerhard Klann, the most experienced member of the team, says the five were three children and their grandparents—and that Mr Kerrey knelt on the grandfather while Mr Klann sliced his head almost clean off.

The team then began moving towards the village. At this point, according to Mr Kerrey and five other members of the team, they were fired upon. They retaliated from 100 yards with heavy weaponry (a report filed afterwards says 1,200 rounds were expended). But when the team came to the huts, they found that all the victims—14 or 15 people—were women and children. None was armed.

The killings are not disputed. But Mr Klann says they happened differently. Mr Kerrey’s team, he says, searched the huts, gathered the villagers together, and executed them. Mr Klann claims the SEALS fired at close range for 30 seconds, waited, then fired again to silence the wounded and the babies. The navy report simply lists 21 Vietcong killed in action.

Given our current state of knowledge, it is not possible to know which story is true. The case against Mr Kerrey is stronger than his supporters have allowed. The bodies were found in a heap, which is consistent with Mr Klann’s accusations. Two Vietnamese who say they were eye-witnesses have corroborated his claims.

Still, enough doubt remains for Mr Kerrey to get the benefit at the moment. The only unquestioned bit of evidence comes from a villager who filed a complaint about the killings the next day. His version chimes better with Mr Kerrey’s than with Mr Klann’s. A navy report says two Chinese carbines were found the next day in the area, giving weight to Mr Kerrey’s story. Above all, part of Mr Klann’s account cries out for explanation. He claims the women and children were killed to prevent them disclosing the team’s presence to nearby Vietcong. But the SEALS fired a deafening barrage, including armour-piercing rockets and grenades, that would have certainly alerted anybody in the area to their presence.

It is tempting to end the discussion there. One day, more facts may make it possible to decide which account is true. But at any event, the two versions must remain separate. Either a war crime was committed or it wasn’t.

Yet the dreadful truth of the incident is that the closer you look, the more the bright line between war crime and tragic mistake begins to darken. Say that Mr Kerrey is right. On his own account, he ordered his team to fire in pitch darkness into a village which, he might reasonably be expected to know, was full of women and children. The deaths were not so much a mistaken by-product of self-defence as an inevitable part of it. It is hard to see how this differs from the reckless endangerment of civilian life seen in, say, the Russian bombardment of Grozny.

What if Mr Klann’s account is true? The deliberate slaughter of civilians would, by the rules of war, be a

crime. And so, arguably, was the firebombing of Tokyo or the destruction of Hiroshima or Dresden—which all involved targeting many more civilians and, in Tokyo, no discernible military targets. Indeed, the man who organised that operation, Curtis LeMay, said that, had America lost the war, he would have been executed as a war criminal.

In those cases, the allied governments justified their actions by saying that they defended soldiers' lives by shortening the war. But Mr Kerrey could invoke that defence too (though he doesn't). In Vietnam, women and children killed American soldiers and helped Vietcong troops stage ambushes. It is unclear whether even the events described by Mr Klann would have been against the rules of engagement at the time. The local (South) Vietnamese official, with the backing of the American military, had labelled Thanh Phong a "free-fire zone", which meant, in the words of the official log kept by the American military adviser, that if any villager did not back the government of South Vietnam, "we will consider you to be Vietcong. You are the enemy. You will die." It would seem that the rules of engagement themselves allowed, even mandated, war crimes.

To say the line is blurred between crimes and the ordinary terribleness of war is not to excuse the former. But the idea that we can draw a bright line between them is central to western attempts to define and arrest war criminals in Kosovo and elsewhere. The Kerrey case shows how hard that effort is.

It also shows how much war has changed. Vietnam produced a generation of American leaders who were forced to confront the moral horrors of war. Men like Mr Kerrey and John McCain may be the last politicians whose views about war are informed by experience on the ground. America is now fighting wars from 30,000 feet, where moral choices are no longer confronted face to face. No American lost his life in Kosovo, but thousands of Serbs and Kosovars perished in collateral damage. Such deaths do not involve the agony that Mr Kerrey and Mr Klann have confronted. Long-distance bombing is reversing Lee's dictum. It would be ill if war were to be sanitised. We might then grow too fond of it.

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Civic trophies

In memoriam

May 3rd 2001 | BALTIMORE AND ST LOUIS
From The Economist print edition

AT THE end of last month, PSINet, a once promising Internet hosting company, was tossed off the Nasdaq market. Bankruptcy looms. Ignominy should follow. Instead, the company will retain its visibility through what is becoming the ubiquitous symbol of dashed corporate promise: a name draped across a big sports stadium.

Sports stadiums—the cathedrals of many cities—were once named after either the town where they were built (Cleveland Stadium), the family that built them (Ebbets Field in Brooklyn), the team that played inside (Yankee Stadium), or fallen war heroes (Soldier Field in Chicago). Nowadays, the cathedrals have become corporate billboards; and the performance of the sponsors indicates that the gods of sport are angry.

The deal that changed things was arguably between Schaefer Brewing and the New England Patriots in 1971. Schaefer's payment, a whopping $2m at the time, helped to build the football team's new stadium. Schaefer Field delivered a certain amount of publicity. But it did not do the trick (possibly because exposure without context is often worthless), and the brewer has since disappeared.

In 1999, PSINet pledged $106m for a 20-year contract to blazon its name on the Baltimore Ravens' new stadium. The team duly won the Superbowl, but PSINet is fighting for its life. Last year, troubled Trans World Airlines (TWA) met the same fate. It paid $36.7m in 1995 for the naming rights of the Trans World Dome. The stadium's tenant, the St Louis Rams, won the Superbowl, and TWA went into bankruptcy.

A coincidence, no doubt. But, a few blocks away from the dome, the local hockey team plays in a stadium that received $72m to carry the name of another technology company, named Savvis, whose largest shareholder, Bridge Information Systems, is now bankrupt. In Miami, the Dolphins frolic in the Pro Player Stadium, named after an underwear manufacturer whose elastic has snapped. In Sacramento, the professional basketball team plays in the Arco Arena, named after a company that no longer exists. Conseco, a troubled insurance business, Bank One, which is in the midst of an extensive restructuring, and Oldsmobile, which will soon cease to be a car marque, all have their names on stadiums.

Technology firms are especially vulnerable. MCI, 3Com, Ericsson and Qualcomm have all bought naming rights, only to see their shares tank afterwards. Soon the New England Patriots will move into a reconstruction of Schaefer Field, sponsored by CMGI, another Internet firm, whose stock price has gone offside. Even so, CMGI will pay almost $8m a year for the next ten years.

So why risk angering the gods of sport? Often, sponsorships come with extras: for instance, the kind of well-situated tickets that cannot be purchased at the box office. For managers of bust companies, the idea of finally having enough time to watch a game under the old logo may be a form of solace. There is also the promotional value—as will surely be explained by the next manager who takes over the naming rights when the current terrific deals expire.

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The Colombian diaspora

Miami nice

May 3rd 2001 | BOGOTA AND MIAMI
From The Economist print edition

THE day after Fernando Botero, Colombia's most famous artist, donated his art collection to his native country, his son Juan Carlos, a political journalist, felt he had to go abroad. A newspaper put the value of the elder Mr Botero's gift at $200m. That made his son, Juan Carlos, an obvious target for kidnappers. The younger Mr Botero tried to take precautions, varying his schedule and driving a bullet-proof car. But in the end he had to leave.

He headed for Miami—where he has found he is not alone. Tens of thousands of middle- and upper-class professionals and entrepreneurs have fled there. Around 1.5m Colombians have been displaced from their homes by violence in the past five years; last year, kidnappers took a record 3,707 people hostage. "Colombians love their country," says Bruce Bagley, of the University of Miami. "But you can't live like that."

Reuters

Miserable about leaving Bogota

The Colombian government estimates that some 800,000 people have left the country in the past four years. Last year, around 366,000 applied for non-immigrant United States visas, more than double the number who applied in 1997. Around 250,000 travelled to the United States on tourist visas (three quarters of them to Miami).

Although most Colombians seek other means of staying in the United States—such as student visas, or temporary work permits, Colombians are now second to Chinese in applying for political asylum. In the fiscal year ending on September 31st, they made 2,747 applications for political asylum (compared with 427 in the previous year); and there were 1,447 cases in the first quarter of the current fiscal year. Two-thirds of these cases are being approved.

Spanish-speaking Miami—closer to Bogota than it is to Denver or Los Angeles—is the logical destination for these professionals. Colombian newspapers and magazines are full of advertisements for Miami properties. Greater Miami is now home to around 130,000 Colombians (around a third of the total in America). They are the second-largest immigrant group in Miami after Cubans. Colombian radio stations in Miami are overtaking Cuban ones as leaders in the Spanish-language market.

Miami is also getting lots of Venezuelans, many of them professionals driven out by President Hugo Chavez's erratic economic policies. Venezuela's GDP fell by 7% in 1999, and billions of dollars of capital have fled the country in the past 18 months. In Key Biscayne, a wealthy island just off downtown Miami, Venezuelans are the main buyers in the beachfront Ocean Club condominium, where the average price of an apartment is $1m; they have also helped drive up house prices by 25% in the past year. Argentines, fleeing their country's economic gloom, are supposed to be the next arrivals.

The new Latin American arrivals range from a doctor who makes a living delivering pizzas, and a construction engineer who used to build roads and bridges for BP, a British oil group, until guerrillas kidnapped him for three months, to the working-class Colombians who pack the Apostolic Mission of Christ, which offers cut-price legal services to new immigrants. Until recession drove away his customers, Sergio Bueno was an up-and-coming bank manager in Bogota handling small-business accounts. Now he runs a valet-parking operation. In his spare time, he is a day trader on the Internet.

Miami has become the capital of the Internet and telecoms business aimed at Latin America. This is partly because it is a good base for any sort of pan-American business. But it is also partly a function of the number of young well-educated Latin Americans flocking to south Florida.

The United States occasionally tries to deter this embarrassment of riches. It recently announced that anyone who had paid a *vacuna* (protection money to gunmen) would be ineligible for political asylum on the basis that he or she had helped a terrorist organisation. This curious interpretation is being contested by some Colombian-American groups. However, for most Colombians in southern Florida, the merest mention of *vacuna* is another reminder of why they wanted to leave their country in the first place.

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At last, justice in Alabama

May 3rd 2001 | BIRMINGHAM
From The Economist print edition

FOR the past 38 years, Chris and Maxine McNair have lived with a void. Their daughter Denise was one of four little girls killed in the bombing, in 1963, of the Sixteenth Street Baptist Church in Birmingham, Alabama. It was 14 years before Robert "Dynamite Bob" Chambliss, a member of the Ku Klux Klan, was convicted for murder in the case; it has taken 24 more for a second Klansman to be found guilty. On May 1st, a jury of eight whites and four blacks convicted Thomas Blanton of the bombing on four counts of first-degree murder. Justice can move very slowly in the South.

AP

Thomas Blanton, 33 years late

When the crime occurred, the FBI found no pieces of the bomb. Witnesses who could have shed light on the case died long before this trial began. Closed mouths did the rest. In the end, Mr Blanton incriminated himself in secret tapes made by the FBI in the mid-1960s. On one tape, he said: "They ain't going to catch me when I bomb my next church."

Mr Blanton continually denied any connection to the bombings. He also denied that he was part of a hard-core group of Klansmen. That is not surprising: Klansmen take oaths of secrecy never to divulge the group's activities, its covert signs or the names of other members. The tapes, said his lawyers, proved only that he was a bad man, not a killer. They plan to appeal against his life sentence.

Tuesday's judgment has been called a victory both for civil rights in the South and for a new group of energetic prosecutors who want to re-examine unsolved crimes from the years of the civil-rights struggle. Even the Birmingham case could have another chapter. An alleged accomplice, Bobby Frank Cherry, now 71, was supposed to stand trial as a co-defendant with Mr Blanton. Prosecutors postponed his case because of ill-health, but he could stand trial if he recovers.

As more of these cases appear in southern courts, the South likes to think of itself as proudly facing the bad ghosts of its past with new-found vigour. Other parts of America, and the world, may well be more struck by the extraordinary length of time it has taken to bring a race-murderer to book.

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Cavallo struggles to get a grip on Argentina's economy

May 3rd 2001 | BUENOS AIRES
From The Economist print edition

After a mauling in the financial markets, Argentina's economy minister has taken refuge in a dose of fiscal orthodoxy and the backing of the IMF

Get article background

Reuters

IN MARCH, when Domingo Cavallo took over for a second stint as Argentina's economy minister, he promised a fresh approach. In place of the austerity meted out by his predecessors, he would use some unorthodox measures to coax growth from a moribund economy, stretching the limits of the country's rigid currency-board scheme, which pegs the peso at par to the dollar and requires the money supply to be backed by hard currency. The result: a panic attack in the financial markets last week that has had Mr Cavallo scurrying to don the clothes of orthodoxy once again.

First, Mr Cavallo announced tax rises and spending cuts aimed at plugging a fiscal deficit that had already overshot the targets negotiated with the IMF in December. Then, on April 29th, the IMF announced its backing for his actions, and said that, if necessary, it would "rephase" (translation: speed up) the disbursement of its aid to Argentina.

Now Argentine officials are talking to investment banks about a bond "swap" (translation: debt restructuring) of up to $20 billion. The aim is to ease the burden of debt falling due in the next few years, and thus dissipate fears of a default, which last week briefly propelled the risk premium on the country's bonds to levels surpassed only by those of Ecuador and Nigeria.

Will it all work? For the next few months, Mr Cavallo faces a difficult balancing act, in which he must maintain financial stability and political support, while he works for a return to growth after a recession that has now lasted almost three years. Ever ebullient, Mr Cavallo claimed this week that, by the end of this year, the economy will be growing at an annual rate of 5%. "We have completely resolved financing for this year," he added. The government is to return to the local money markets, after having been forced by soaring interest rates to cancel an auction of treasury bills last week.

But if investors are to be reassured, Mr Cavallo's first priority must be to meet the target of $6.5 billion—or 2.2% of GDP—for this year's fiscal deficit. Already, in the first three months of this year, the deficit outstripped its $2.1 billion target by $1 billion. Tax revenues slumped again in April.

One of Mr Cavallo's first measures was to introduce a tax on financial transactions. Now he has increased that (from 0.25% to 0.4%), and removed almost all exemptions from the country's sales tax—prompting howls from cable-television operators and newspaper owners who, rather improbably, have claimed that the levying of sales tax on their industries was an attack on freedom of speech. Between them, these measures should raise some $3 billion. Mr Cavallo also announced public-spending cuts of around $900m, at least half to come from the reorganisation of welfare spending.

The rot from the past

Although Mr Cavallo is not the sort to admit it, this is an about-face. During his first month in office, he boosted his popularity by playing to the public, spurning investors' demands for details of his economic plans. After a morale-boosting start, Mr Cavallo then confused markets with an ill-timed proposal to amend the currency board so that the peso might in future be pegged half to the dollar and half to the euro.

But fiscal austerity will not in itself produce growth: three previous austerity packages during the 17 troubled months of President Fernando de la Rua's government only prolonged the recession, driving down tax revenues and thus broadening the deficit. So Mr Cavallo is trying to combine fiscal orthodoxy

with looser monetary policy and a bundle of investment incentives.

This is controversial. Mr Cavallo's monetary plan was opposed by Pedro Pou, the head of the supposedly independent central bank, who was obliged to resign last week over a gathering money-laundering scandal. Mr Cavallo wants to increase liquidity by, for example, allowing Argentina's banks to use government bonds as part of their compulsory reserves. Mr Pou argued that this would weaken the financial system. But others disagree. If put into practice carefully, a looser monetary policy could help to support lower interest rates and growth, argues Vladimir Werning of J.P. Morgan Chase, an American bank.

One of Mr Cavallo's first measures was to abolish tariffs on imported capital goods and raise them on consumer goods. Among his latest measures is a halving of the sales tax on capital goods. He is also working on cutting other taxes for labour-intensive industries, such as textiles and shoes.

Whether that will speed growth is not clear, but it has given Mr Cavallo political support denied to his predecessors. Despite the market turmoil, he is relatively popular. At least before the latest tax increases, one poll found Mr Cavallo to be Argentina's most popular politician, even though only 45% approved of him. "Cavallo, unlike other politicians, grows in stature in office," says Artemio Lopez, a political analyst.

But there are political clouds. A judge has cited Carlos Menem, Argentina's president from 1989 to 1999, for questioning over a scandal involving the illegal export of arms to Croatia and Ecuador. Other skeletons from the Menem years are coming back to life: the United States has turned over to Argentine congressional investigators documents which may reveal new details of money-laundering and corruption. The Peronist opposition, which has a majority in the Senate, is rallying round Mr Menem. But its threat to sabotage the government's economic programme may be an empty one. Nowadays, the most powerful Peronists are provincial governors, not Mr Menem; they would benefit from the economy's revival.

The bad news for President de la Rua is that "not a drop" of Mr Cavallo's popularity falls on the government, since the minister is "seen as a prosthesis", according to Mr Lopez. With consumers still depressed, Mr de la Rua's Alliance is set for a drubbing in the congressional election due in October, and could break up as a result. The good news is that if Mr Cavallo, and confidence in Argentina's debt and currency, can survive till then, all may outlast the Alliance. But, for Argentina, October seems a long way off.

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Back to square one in Chiapas

May 3rd 2001 | MEXICO CITY
From The Economist print edition

Get article background

AP

The clash of laws

HOPES for peace in Mexico's south-eastern state of Chiapas have receded once again. After much wrangling, Congress approved constitutional changes last weekend that grant special rights to Mexico's 60-odd Indian peoples. This reform, submitted by President Vicente Fox, was one of the conditions set by the Zapatist rebels in Chiapas for peace talks. But in approving it, Congress watered it down. The Zapatists' leader, the self-styled Subcomandante Marcos, quickly retorted that all talks were off.

Was this justified? The original bill would, in theory, have given Indian communities limited autonomy, self-government and control over the lands they live on. Those who altered it were conservatives, in both Mr Fox's National Action Party (PAN) and the formerly-ruling Institutional Revolutionary Party (PRI). They claimed that the bill would damage the unity of the country. More privately, they feared it would hurt the interests of local bosses and landholders, particularly in Mexico's southern states, where land disputes are common.

The law, as passed, substitutes Indian communities' right to the "collective use and enjoyment" of their land—which could have threatened landowners—with a vague "preferential use". It also denies to Indian communities the status of legal entities, such as a town council enjoys. Most of the other changes, though, merely involved reiterating that state and federal laws took precedence over any local "autonomy" or special provisions—as the constitution says anyway.

Whichever text had passed, it would make no immediate difference to the Indians' lives. Many Indian communities already enjoy much more autonomy than any law would permit, simply because local authorities prefer not to meddle with them. The real test of the government's attitude will be in the secondary laws it passes, how it enforces them, and in practical schemes for education, job-creation, corruption-fighting and social services.

The immediate question, though, is how to end the smouldering conflict in Chiapas. It will not now be by meeting the Zapatists' demands. Together, the PRI and the PAN control nine-tenths of Congress. Moreover, that body is now in recess until September. It will have more urgent business when it reopens, such as a long-awaited fiscal reform.

That leaves the Zapatists, and their Indian supporters, with a dilemma—whether to go along with a weakened reform, or keep fighting for a better one. It is hard to see how the rebellion can go on. Mr Fox campaigned for the bill, ordered police protection for a two-week Zapatist peace cavalcade to Mexico city, and jovially brushed off the rebel leader's persistent barbs. Now he is publicly lamenting the crippling of the bill and promising to do all he can to make up for it. The sympathy the Zapatists' cause won at home and abroad helped to end the PRI's 71-year rule in last year's elections. They will find it harder to dent Mr Fox's carefully cultivated image as a peace-monger.

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Canada

Dog day

May 3rd 2001 | OTTAWA
From The Economist print edition

Get article background

LAST year, conservatives in Canada thought they had come up with a winning plan to oust the Liberal government of Jean Chrétien. In an effort to unite the divided right, the Reform Party, strong in the western provinces, joined forces with sections of the Progressive Conservative Party in a new Canadian Alliance. They chose as their leader Stockwell Day, a fresh-faced and seemingly bright Albertan. But little has gone right for the Alliance—or for Mr Day.

The problems began at the Alliance's birth, when Joe Clark, the Conservative leader, refused to join. The second setback came when Mr Chrétien called a snap election in November, which he won with an increased majority. Since then, Mr Clark, who was once briefly prime minister, has shone in parliamentary skirmishing with Mr Chrétien over a shady golf-course deal, while Mr Day has stumbled as leader of the opposition. Discontent came to a head last month when his chief of staff and four members of his shadow cabinet resigned from their posts. Even Ralph Klein, Alberta's premier and Mr Day's former boss, has said that time is running out for the leader. On May 2nd, Mr Day presented his MPs with a draft strategy, drawn up by outside consultants, which seemed to contain the revolt—or at least to buy himself some more time.

Mr Day can claim that in the election he did well to add 700,000 votes and six more seats—making 66 in total—to Reform's haul in the 1997 election. His critics counter that he fumbled the campaign. He failed to work with the Conservative machine in Ontario, where he won only two of 103 seats, and he flip-flopped on big issues. Since then, he has attracted ridicule for landing Alberta's taxpayers with legal costs of C$700,000 ($460,000) for a libel case when he was a minister there. More trouble followed over whether he had agreed to hire an American detective to spy on the Liberals. His critics within the Alliance claim that he makes erratic decisions, and without consultation.

Support for the Alliance has crumbled to 13%, down from 25% on election day, and behind Mr Clark's Conservatives (15%), according to a recent opinion poll. More pointedly, the poll showed that Mr Clark was twice as popular as Mr Day in Alberta.

But the Alliance lacks an obvious replacement for Mr Day. Preston Manning, who led Reform, might welcome a recall, but in public says he plans to leave politics later this year. Mr Clark is too much of a centrist "Red Tory" to appeal to the social conservatives of the Alliance. Mike Harris is an obvious choice after six successful years as Ontario's premier. But he seems to enjoy his present job, not least since power in Canada is increasingly moving to provincial level.

Another problem is that the Alliance's MPs cannot by themselves remove their leader, since he was directly elected by party members. A vote on his leadership is not due until a party convention in 2002—unless Mr Day resigns. That looks unlikely. Last week, he commended Queen Elizabeth for saying that at 75 she had no plans for retirement, adding that, at 50, neither did he.

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Chile

A dimming star

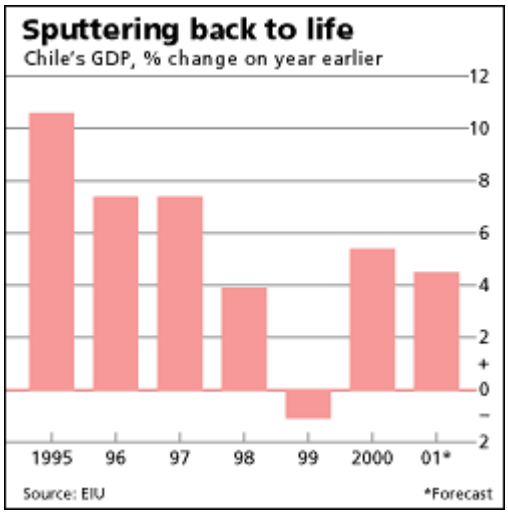
May 3rd 2001 | SANTIAGO
From The Economist print edition

THE public finances and inflation are well under control, the current-account deficit is less than 2% of GDP and, after a sharp recession in 1999, the economy is growing steadily again. Across the Andes, in Argentina, all of this would amount to nirvana. Yet many Chileans, especially those in business, have in recent months become deeply pessimistic about their country and its economic prospects. Why?

One reason is that, though exports are growing again, the domestic economy is recovering more slowly. Investment, which plunged by 17% in 1999, was up by only 4% last year—albeit by 12% in the last quarter of the year, compared with the same period in 1999. Unemployment remains high at 8.8%, and will rise again during the coming (southern-hemisphere) winter. Another reason is the outside world: there are worries, not just about Argentina, but that slower world growth could cut the price of copper, still Chile's largest export.

Long Latin America's best-performing market economy, Chile had grown used to high growth, which averaged 7.6% a year in the ten years to 1998 (see chart); anything less is now seen by Chileans as a disappointment. To add to the malaise, both government and business have their own problems—and are not getting on together.

President Ricardo Lagos, a moderate socialist who took office in March 2000, has a majority in both houses of Congress, though of only one seat in the Senate. But economic bills that should have been approved months ago are still bogged down. That has created uncertainty. The delayed laws include changes in labour legislation and a bill to reduce tax evasion. Businessmen oppose both measures, though they would doubtless adapt to them once they were in force. Ironically, another pending law would reduce bureaucratic delays on new investment projects by automatically granting permits if a government office failed to give an answer within a stipulated period.



The delays are mainly the result of divisions in Mr Lagos's centre-left coalition, the Concertacion, which has governed since 1990. These have been exacerbated by a municipal election last October and the promise of a congressional one in December.

The Concertacion's splits are sending a muddled message to business. For example, the government's energy office has been raising regulated electricity prices, to stimulate new investment and avoid a potential power shortage next year. But a group of Concertacion congressmen are complaining that the office is in the pocket of the privatised electricity industry. Similarly, a recent decision to offer management contracts for two state water companies, rather than selling them, was seen by the private sector as a victory for government supporters who are critical of earlier privatisations.

"The government blames us for not investing and for high unemployment, but we react to the signals we receive," complains Ricardo Ariztia, who heads the main private-business lobby. Chilean businessmen, most of whom are right-wing, are indeed ultra-sensitive to such signals, or to anything that smacks of what they see as the danger of a "socialist government". They do not distrust Mr Lagos or his economic team, but they are predisposed to interpret policy changes as a sign of encroaching influence from the Concertacion's left wing, which, they complain, has never accepted the free-market policies introduced by General Augusto Pinochet's 1973-90 dictatorship.

The lack of business confidence also has other causes. Under General Pinochet, Chilean businessmen acquired inefficient state firms cheaply on the eve of a sustained economic boom, and then expanded rapidly both at home and elsewhere in South America. Now they face much tougher competition—and a

lower return on capital. Foreign firms, especially from Spain, have taken over many Chilean companies, breaking up the country's tightly-knit business community in which everyone knew everyone else.

The government, as much as business, is dissatisfied with the prospect of a growth rate of 4-5%. Even with tighter controls on tax evasion, this would not produce the revenue needed to finance its planned social programmes. Improvements in education are especially urgent if Chile is to develop more high-value industries.

Officials are coming to recognise that they need to do more to attract capital. The Lagos government has dismantled controls on foreign capital flows, which in more affluent days were seen as a defence against "speculators". It also plans legislation to encourage private saving and shareholding.

How long the government takes to win approval for this will be one pointer to the Chilean economy's future prospects. Another would be any sign of business and government starting to work together to improve the country's education system.

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More mayhem in Manila

May 3rd 2001
From The Economist print edition

This week's events cast a shadow over democracy in the Philippines

REBELLION, riot or attempted coup? Whatever it was that happened in Manila this week was almost certainly connected to the congressional election due on May 14th.

Reuters

Most of the politicians who egged on the demonstrators—and who are accused of instigating an assault on the presidential palace—were supporters of Joseph Estrada, the president ousted in January. They sought to capitalise on Mr Estrada's arrest last week, and boost their flagging support before the election. And Gloria Macapagal Arroyo, who took over from Mr Estrada, is now accused of playing politics herself. On May 1st, after thousands of security forces had repelled an attack on the palace, she invoked special powers, and ordered the arrest of several opposition senators without warrant.

When the demonstrations began last week, Mrs Arroyo's initial responses were liberal enough. For five days after Mr Estrada's arrest on April 25th, she allowed his supporters to hold large protests in central Manila. The arrest itself had been carried out by the book, and was based on volumes of evidence from the former president's impeachment trial. But however much he may have stolen from the poor, as well as the rich, many of them still view Mr Estrada as their champion against the prosperous families who dominate the country. To his supporters, Mrs Arroyo, the well-educated daughter of a former president, is just another scion of that elite.

Although some of the protesters seemed genuinely angry, others had clearly been paid. Much of their supposedly spontaneous indignation came across as carefully orchestrated. And long before things turned ugly, most observers reckoned they knew who was leading the band.

Yet Mrs Arroyo continued to let them demonstrate, insisting that free assemblies were fine so long as they did not become violent or attempt to unseat the government. To be safe, she had Mr Estrada transferred to a hospital, and then to a barracks. But she resisted calls by some of her own supporters to evict the mobs from the monument that had been the focal point of the rallies that toppled Ferdinand Marcos in 1986 and Mr Estrada earlier this year. One anti-Estrada pundit had accused the crowds of "desecrating the shrine" to democracy, since their "people power III" campaign lacked the purity of the previous two popular explosions. Mrs Arroyo did not buy it.

When a mob of 20,000 eventually headed for the Malacanang presidential palace, a couple of hours after midnight on May 1st, it took them several hours to overrun four checkpoints. They were armed with clubs, knives, stones and other weapons picked up along the way. It took riot squads six hours to disperse the attackers, apparently because most of the troops exercised restraint: they relied largely on tear-gas, water cannon, shields and clubs, and shots fired in the air. Some, however, were filmed clubbing the protesters. Many of those wounded had been shot in the legs, suggesting that some of the troops had aimed low. At least four people—one policeman and three civilians—were killed, and more than 100 were injured.

Mrs Arroyo reacted to the assault by declaring a "state of rebellion", in Manila and the surrounding area. For this, unlike the much more draconian declaration of martial law, she had no need to seek congressional approval. Citing her new authority, though lawyers are challenging the legality of it, Mrs Arroyo promptly ordered the arrest of 11 opposition politicians without warrants. The decision seemed hasty—and all the more so when she appeared on television looking haggard and exhausted.

The opponents Mrs Arroyo has picked on will not have much sympathy among Manila's middle classes. They include several of the senators who had helped to balk the impeachment of Mr Estrada before he was thrown out. The first to be arrested, Juan Ponce Enrile, is a serial offender, having been arrested for

trying to overthrow Corazon Aquino's government in the late 1980s. Another, Gregorio Honasan, also led a failed coup attempt against Mrs Aquino.

Nevertheless, their arrests were hardly necessary to restore calm to Manila. Edgardo Angara, an opposition senator who is not among the accused, declared that Mrs Arroyo's decision had "everything to do with party, rather than the merits". Her actions look even more troubling in light of two recent tendencies. One is the diminutive president's readiness to use tough language—her favourite new word is "crush"—which she employs at times almost to dare opponents to defy her. The other, closely related, is her frequent reference to the "united armed forces" that stand behind her.

United the troops may be, but when put to the test Mrs Arroyo works harder to appear strong than to appear fair. That may prove a sure recipe for a divided nation, whatever happens on May 14th.

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Indonesia

Strike two against Wahid

May 3rd 2001 | JAKARTA
From The Economist print edition

PARLIAMENT notched up another strike in its impeachment efforts this week. On April 30th, its members voted decisively to send a second censure letter to Indonesia's president, Abdurrahman Wahid, accusing him, rather vaguely, of breaking state guidelines and the constitution. They must now wait until the end of May before they can try for strike three, at a special session of the assembly that elected him, which combines the 500-member parliament with 200 other, mostly regional, representatives. During that special session, which is being pencilled in for late July or early August, Mr Wahid's opponents plan to end his presidency three years early.

Though the censure motion was technically a warning—it raised concerns that Mr Wahid is meant to attend to within a month—most members of parliament intend to ditch him no matter how he responds. As their effort gathers speed, they are wasting less time on the specific charges that led to the first censure: that he was involved in two financial scandals. Whether Mr Wahid is guilty or not—a parliamentary committee found only circumstantial evidence against him—those charges were always a pretext for ousting him on broader grounds. So, unlike the first censure motion, the second does not invite the courts or new investigators to get involved. The impeachment drive is an openly political affair conducted by a political body.

And Mr Wahid is politically feeble. His small National Awakening Party controls only 10% of parliament, and all the big parties are against him. The most powerful politicians resent being cut out of his government, which at first contained ministers from all the big factions. The backbenchers, meanwhile, are out to assert parliament's authority, after 32 years of autocracy under the former president, Suharto.

Moreover, although parliament must share the blame for Indonesia's problems, Mr Wahid's failures during his 18 months in office have undermined his authority to fight back. As one opposition politician puts it, "If he could fix his way of governing, if he could mend the economy, if he could stabilise the nation, if he could save the currency, what's wrong then with maintaining Gus Dur?" Gus Dur is Mr Wahid's nickname.

Crucially, the Indonesian Democratic Party of Megawati Sukarnoputri—Mr Wahid's vice-president and constitutional successor—continues to echo these sentiments. Before the censure vote, the party stressed that the financial scandal was only part of the problem. Its real gripe is that Mr Wahid has not changed his "attitude, behaviour, policies and actions" during the three months since the first vote. If Mr Wahid does not find a convincing way to give the party power, its members will simply take it.

Mr Wahid has put little effort into bringing about the necessary compromise. The only concession he made this week was to ensure that a large rally by his supporters remained peaceful. That represented at least temporary progress: he had recently winked at his supporters while they destroyed opposition offices, and has hinted that they would do worse if parliament unseated him. But in a televised address on May 2nd, Mr Wahid said little about parliament's censure vote two days earlier. And his efforts behind the scenes have been just as cursory.

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Rabble rousing in Asia

May 3rd 2001
From The Economist print edition

AUTOCRATS love big protests—if they happen in other countries. When such demonstrations turn violent, Asia's repressive regimes exploit them at home. Since 1998, for example, Malaysia's pro-government media have gleefully broadcast images of violent rallies in nearby Indonesia. By showing such riots, governments hope to erase the distinction between criticism and mayhem, and discourage both.

AP

Jeyaretnam defiant

Malaysia's government does not take any kind of disobedience lightly. It grants few licences for free assemblies. When illegal ones are planned, police detain opposition leaders, choke off roads and turn cars away from rallying points. Peaceful protests, especially those supporting the jailed, former deputy prime minister, Anwar Ibrahim, are sometimes broken up with tear-gas and water cannon.

Last month, not long before a large demonstration marking the anniversary of Mr Anwar's sentencing, Malaysian police rounded up anti-government activists, mostly from the opposition Justice Party. The police say that the activists were planning terrorism, complete with bombs. They did not need any evidence of this. Malaysia's Internal Security Act lets the police detain people for long periods without trial.

By these standards, even neighbouring Singapore is making progress. On April 28th, around 2,000 people showed up for an anti-government rally, the first of its kind since independence. The star of the show was Joshua Jeyaretnam, an opposition MP (a rare breed in Singapore). Mr Jeyaretnam will lose his seat unless he pays hefty debts incurred after losing defamation suits. Unlike Mr Jeyaretnam, many dissidents in Singapore are afraid to say or write anything critical about government officials. The opening last year of a "Speakers' Corner" has not changed this. But last week's rally may be a sign of changes to come.

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Europe discovers North Korea

May 3rd 2001 | SEOUL
From The Economist print edition

IN ANOTHER contact with the real world, North Korea's leader, Kim Jong Il, received a delegation from the European Union on May 2nd. It got the sort of old-fashioned welcome to the capital, Pyongyang, that other communist states always used to put on. Hundreds of women dressed in national costume and waving pink plastic flowers chanted the words "Sincere Welcome". Goose-stepping soldiers reminded the delegation that even in poor North Korea the army is well looked after. Then the Europeans were wined and dined. Mr Kim pleased his visitors with a pledge to maintain his moratorium on missile-testing until 2003.

The delegation was led by Goran Persson, the prime minister of Sweden, which holds the presidency of the EU. North Korea may have a soft spot for Sweden, which was one of the few countries to keep up diplomatic ties during the cold war. Probably a bit of extra warmth was needed for this visit. The backslapping that took place last year, with visits by South Korea's president and America's then secretary of state, now seems rather distant. Since George Bush took over from Bill Clinton, things have cooled between North Korea and the United States.

The State Department says that North Korea sponsors international terrorism, and Mr Bush's enthusiasm for an anti-missile shield is ostensibly directed at North Korea's missile production. Even more to the point, Mr Bush says he wants to see North Korea reciprocate in response to concessions made by others, not just promise later changes. And the iciness has spread. The North ended talks with the South after the South's president visited Washington in March.

South Korea, though, seems determined to keep up its "sunshine" diplomacy with the North. It plans to ship to its impoverished neighbour 200,000 tonnes of fertiliser this spring, and more economic aid may be in store if Kim Jong Il makes his promised visit to the South this year. But Mr Kim will have to bring a present, which South Korean officials hope will be some tangible ways to reduce tensions on the peninsula. A military hot-line and an exchange of military officers to observe how each command works would be a start.

With a presidential election in the South less than two years away, the North's leader has little time to waste. The next southern leader may be less generous with the sunshine. That perhaps was the message Mr Persson took to Pyongyang.

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Sri Lanka

Tiger teeth

May 3rd 2001
From The Economist print edition

“AN ATTACKING force always sustains more casualties,” said a Sri Lankan army commander, seeking to dismiss the army’s large losses in an attack on Tamil Tiger rebels. The army said 157 of its soldiers and 190 rebels had been killed. The Tigers said it had killed 300 soldiers for the loss of 48 of its own fighters. Whatever the true figure, it was a ferocious battle. Worse, the army appeared to have gained nothing from it.

It had apparently aimed to capture the town of Pallai as a prelude to retaking the more important Elephant Pass, a causeway linking the Jaffna peninsula to the southern mainland. Last year the army lost control of the pass in its worst defeat in the 18-year civil war. Without this land route, the government can supply its troops in the Tamil-dominated peninsula only by sea or by air. An offensive, named Rod of Fire, started on April 25th immediately after the Tigers had ended a unilateral truce. The Tigers put up strong resistance, forcing the troops, drawn mainly from the majority Sinhalese population, to retreat to their original positions in Nagar Kovil, Eluthumadduval and the Kilaly lagoon. On April 28th, it was all over and both sides were disposing of their dead.

The debacle has panicked the government. The stalling of a major offensive led by the cream of its recently modernised armed forces has exposed the precariousness of its grip on the peninsula, which was wrested from the Tigers only in 1996. The government’s earlier claim that the Tigers had called their ceasefire out of military weakness is looking increasingly hollow.

This could explain the hasty arrival in Colombo this week of Erik Solheim, a Norwegian envoy trying to bring an end to the war, which has claimed an estimated 64,000 lives. The government no doubt fears an attempt by the Tigers to retake Jaffna city, once their stronghold. Mr Solheim is one of the rare outsiders the Tigers seem to trust. The government may be hoping that he can persuade the rebels to desist from attacking the city. However, even Mr Solheim may be unable to soothe the Tigers in their present fighting mood. They are anyway annoyed with western countries for ignoring their pleas to press Sri Lanka to match their ceasefire. Instead, the Tigers fume, the United States lectured them on the futility of their cause, while the British government made them close their office in London.

If the Sri Lankan government wants the Tigers to discuss peace, it may have to agree to their pre-talks demands, including the lifting of economic restrictions on Tiger-controlled areas, and a ceasefire. The alternative could be the loss of Jaffna, strengthening the tigers’ case for self-determination leading to a separate Tamil state.

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India

Stalin's sickles

May 3rd 2001 | DELHI
From The Economist print edition

THE well-being of 202m people may be at stake, but it is hard not to dwell on the theatrical side of next week's elections in five states. In two, West Bengal and Kerala, the governments are led by avowed hammer-and-sickle Communist parties; in another, Tamil Nadu, a fellow named Stalin (not, in fact, a Communist) has a central role.

The main challengers in the two biggest states are women of notoriety. In Tamil Nadu, ex-film star, ex-chief minister and convict, Jayaram Jayalalitha, may well unseat the government led by Stalin's father, even though she has been banned from standing because of her corruption conviction. Meanwhile in West Bengal, the temperamental Mamata Banerjee, who may have great flair for politics but showed none for administration during a spell as railway minister in Delhi, has a good chance to end 24 years of Communist rule. Most observers, however, think she will just miss.

By rights Bengalis should have become tired of a quarter-century of Communist rule. But the Communists have a strong rural organisation and a new chief minister, who is relatively young by the standards of his octogenarian predecessor. Miss Banerjee, who is impregnable in Calcutta but less so elsewhere in the state, has failed to unite the anti-Communist parties.

The main interest in May 10th's elections lies in the clues they will offer to, and the impact they will have on, the opinions of Indian voters about the two main parties, the Bharatiya Janata Party (BJP), which rules at the head of an unwieldy coalition, and the opposition Congress party.

The stakes are higher for Congress than for the ruling BJP, according to E. Sridharan of the University of Pennsylvania Institute for Advanced Study of India in Delhi. Congress has a good chance to take power in two states, Kerala (where the Communists are in power, but vulnerable) and Assam, where the incumbent government is trying to save its skin by linking up with the Hindu-nationalist BJP, to the alarm of the state's many Muslims.

Success in either state or both would provide a much needed buffing for its tarnished credentials as the leading opposition party at the centre. The BJP's highest hope, by contrast, is its proposed alliance in Assam with the Asom Gana Parishad. It has nowhere to go but down.

The elections are not directly a referendum on the performance of the BJP. Only in Tamil Nadu is the ruling party a member of the national alliance. And there, despite her legal handicap, the opposition leader Miss Jayalalitha has two near-constants of Indian politics in her favour, disenchantment with the state government and pre-poll alliances. Such friendships are fleeting: on a whim a party leader can shift the votes of a caste grouping from one alliance to another. In this election Miss Jayalalitha's lot is expected to benefit from the votes of Vanniyars, a poor caste prominent in northern Tamil Nadu whose leader deserted the national alliance shortly before the election.

But if the BJP is not directly in the firing-line this time, its moment is soon to come. Its big test will be when its government in Uttar Pradesh, the biggest state in India, faces the voters. That is likely early next year.

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Japan

Substance or just style?

May 3rd 2001 | TOKYO
From The Economist print edition

Junichiro Koizumi arouses great expectations. Expect great disappointments

POLITICS is in crisis. The people despair. A dashing reformer appears. The people rejoice. The reformer fails. The people despair. Never mind the surge of hope that has lifted Junichiro Koizumi, Japan's new prime minister, into power. Tokyo's hard-bitten political hacks think they have seen it all before.

In 1993, a maverick politician, Morihiro Hosokawa, took power with promises of reform. By the following April, this bold new leader had resigned. Mr Koizumi has Mr Hosokawa's looks, charisma and heterodox appeal, though the match is not perfect: not even Mr Hosokawa was as popular.

Accounting for Mr Koizumi's instant and overwhelming popularity is by no means easy. He comes from the same party, the discredited Liberal Democrats (LDP), as his ridiculed predecessor, Yoshiro Mori. Mr Koizumi and Mr Mori even come from the same wing of the LDP, the Mori faction, which has a distinctly conservative colour.

Mr Koizumi has already taken a new broom to some corners of Mr Mori's cabinet (see table). But some of Mr Mori's old dinosaurs have won themselves another term in office. The two men even share many policies: Mr Koizumi's first job will be to push through an economic bundle that Mr Mori drew up in April. There is one big difference, though. In its final months, Mr Mori's cabinet had an approval rating in single figures. Amazingly, Mr Koizumi's tops 80%.

Something old, something new
Junichiro Koizumi's administration

Position	Name	Age	LDP faction	New broom/ old dinosaur rating
Chief cabinet secretary	Yasuo Fukuda	64	Mori	
Finance	Masajuro Shiokawa	79	Mori	
Economic & fiscal policy	Heizo Takenaka	50	Not in Diet	
Foreign	Makiko Tanaka	57	None	
Defence	Gen Nakatani	43	Kato	
Home affairs, posts & telecoms	Toranosuke Katayama	65	Hashimoto	
Justice	Mayumi Moriyama	73	Former Komoto	
Economy, trade & industry	Takeo Hiranuma	61	Eto-Kamei	
Financial affairs	Hakuo Yanagisawa	65	Horiuchi	
Administrative reform	Nobuteru Ishihara	44	None	
Education	Atsuko Toyama	62	Not in Diet	
Science & technology	Koji Omi	68	Mori	
National public safety	Jin Murai	64	Hashimoto	
Agriculture	Tsutomu Takebe	59	Yamasaki	
Environment	Yoriko Kawaguchi	60	Not in Diet	
Land, infrastructure & transport	Chikage Ogi	67	(New Conservative Party)	
Health, labour & welfare	Chikara Sakaguchi	67	(New Komeito party)	

Source: *The Economist*

Part of Mr Koizumi's appeal is his flair for theatre. He looks good. He sounds good. He plays the press skilfully. Where Mr Koizumi has made cabinet changes, he has brought in slick performers, like himself: Makiko Tanaka as foreign minister, for instance, and Heizo Takenaka, a bouncy academic, as economics minister. Mr Mori was a backroom co-ordinator. In the glare of the television cameras, he seemed old-fashioned and oafish. Mr Koizumi is a thoroughly modern politician, with an ear for the right soundbite. There may be fierce resistance to his plan to "change Japan", he says, "but I must grit my teeth and face

it.”

Unfortunately, counter the cynics, these soundbites are creating unrealistic expectations of change. As Mr Koizumi runs into opposition to his reform plans—from his own party, his coalition partners, bureaucrats and businessmen—his ratings will falter and he will fail, just as Mr Hosokawa did. Yasuo Fukuda, the government’s top spokesman, seems as uncomfortable with Mr Koizumi’s soaring popularity as he was with the cabinet’s dismal ratings when he served under Mr Mori. Thank you for the vote of confidence, Mr Fukuda told reporters this week. The new government would certainly do its best not to let the people down.

In the newspapers and on the talk shows, meanwhile, the Koizumi revolution marches on. He plans to clean up the banks, voters are told, and restore competitiveness to once world-beating industries. He will sort out the government’s debt problem and balance the budget. He will overhaul the bureaucracy, change education and reform the legal system. He will even rewrite the constitution. There will be nothing sacred in his zealous pursuit of structural reform.

Mr Koizumi clearly over-reaches himself a bit. But those who patiently wait for him to honour his extravagant promises may be missing the point about what has really changed in Japan. It is not just the LDP’s old-fashioned policies that turn off the voters, but its stubbornly old-fashioned way of conducting politics. Its policy presentation is execrable. Its leaders are old and unattractive and they mumble their lines, even when they read their speeches. Regardless of the substance, on which the jury is still out, Mr Koizumi represents a new style of politics in Japan. His rise to power is a sign that Tokyo’s spin-free political world has at last woken up to the role that the media play in politics everywhere else.

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A Eurovision song contest

May 3rd 2001 | BRUSSELS
From The Economist print edition

Germany's chancellor, Gerhard Schröder, has proposed far-reaching plans for further European integration. The Union's other big countries are doubtful

THE first entry came from Germany's foreign minister, Joschka Fischer. Almost exactly a year ago, he kicked off the Eurovision contest with a catchy little number entitled "From Confederacy to Federation; thoughts on the finality of European integration". Ever since, a succession of European leaders has trudged to the microphone, with rival visions of the European Union's future. Jacques Chirac, the president of France, appeared live at the German parliament and sang the praises of the nation-state. Tony Blair, Britain's prime minister, went to Warsaw to release a single entitled "A superpower, not a super-state". Minor artists like Guy Verhofstadt, the prime minister of Belgium, and Toomas Ilves, Estonia's foreign minister, have sung a more federalist tune. But the latest release has come from none other than Gerhard Schröder, Germany's chancellor. An abbreviated bootleg copy of his ruling Social Democratic Party's song for Europe appeared on April 30th in *Der Spiegel*, a German magazine, prompting the party to put out the whole score.

The Schröder-SPD version of the Union's future has a familiar Germanic lilt to it. Like Mr Fischer a year ago, Mr Schröder lays a strong emphasis on transforming the EU from a collaborative club of nation-states into something much more like a federation, along the lines of the Federal Republic of Germany or the United States.

Such a vision inevitably sets alarm bells ringing in London and Paris. But any attempt to make sense of the debate on the future of the European Union has to distinguish between two crucial, if related, questions. The first is how to divide power among the various institutions of the EU, known collectively as "Brussels". The second is how much power Brussels should have relative to the countries that make up the EU.

Much of what Mr Schröder had to say concerns the first question. In essence, he wants to strengthen the two institutions said to represent pan-European interests: the European Parliament and the European Commission, a policymaking bureaucracy. And he wants radically to weaken the Council of Ministers, the institution that represents the EU's individual countries. Under the Schröder plan the council, which brings together ministers from governments who then legislate together for the Union, would be turned into a second chamber of the European Parliament, on the lines of the German Bundesrat or the American Senate. Meanwhile, the commission's claims to be democratic would be boosted by ensuring that its president was elected by the European Parliament.

All in all, these changes would probably make it much easier for "Brussels" to gets its way in any tussles with the nation-states. At present much European legislation can still be blocked by vetoes exercised by governments through their representatives in the Council of Ministers. Although Mr Schröder's plan lacks detail, the thrust of it suggests that it would become much harder for individual countries to block EU

decisions, if the council became just a second chamber of Europe's parliament.

That would make the division of powers between the nation-states and the EU still more crucial. Germany's Social Democrats are not proposing a one-way flow of power to Brussels. Indeed, they want to repatriate certain powers to national capitals, notably over agricultural policy and regional aid. In other areas, however, Brussels would become stronger. Mr Schröder and his colleagues also want the EU to have a greater say over immigration, policing, social policy and taxation (see article).

The German plan at first drew cross-party assent at home: Germany is easily the single biggest contributor to the EU's budget—of which 80% is spent on agriculture and regional policy. Repatriating those policies would mean that Germany paid much less towards the EU. The plan would also strengthen Germany's institutional weight relative to other countries'. But even so the opposition Christian Democrats' leader, Angela Merkel, later said it would give too much power to Brussels.

France has fought tooth-and-nail to ensure that, even though Germany has the biggest population of any EU country, it has no more votes in the Council of Ministers than the other big ones—Italy, Britain and, of course, France. In the European Parliament, however, the weight of German population is acknowledged with a greater number of parliamentary seats, though small countries are still over-represented. So strengthening the parliament relative to the council boosts German influence.

These implications will not be missed in London and Paris. Both the French and the British are likely to resist the downgrading of the Council of Ministers. France's minister for Europe, Pierre Moscovici, was quick to rubbish the plan. France will not like the budgetary implications, especially concerning the EU's common farm policy, which favours it; and Britain will resist stronger EU powers to set tax and social policy.

That said, there are other aspects of the document that may win plaudits in London and Paris. The French are keen on bigger powers for the EU over tax regimes. They have also come out in favour of an indirect election of the commission's president. And Britain's Mr Blair favours the idea of a clearer division of powers between Brussels and national capitals. He too has proposed a second chamber for the European Parliament, in his version one with members drawn directly from national legislatures.

The Italians, usually keen on a federation for Europe, will like the German plan, though that might change if Italy's coming election leads to a government that includes the Northern League, which is less friendly to EU integration. The Spanish will be much more wary, since they have won a very sweet deal in the Council of Ministers, getting 27 votes to Germany's 29, with only half the population; they fear anything that threatens their grasp on EU regional aid.

The attitude of the EU's smaller countries is harder to gauge. The Nordics tend to look askance at anything federal. Austria has already expressed misgivings. The Benelux countries, on the contrary, will welcome a plan to bolster European institutions.

The rush to release new entries for a Eurovision contest may seem premature. After all, Europe's next treaty to cater for all such questions is not due to be signed until 2004. But the agenda for the negotiations will be set a lot sooner. The EU's leaders are due to make a declaration on Europe's constitutional future at a summit in the Belgian town of Laeken in December. Unlike the real Eurovision song contest, no one entry will be declared the winner. The real question is whether all the different songs can be blended into a single harmony; or whether discussions at Laeken and after will turn into a discordant cacophony of clashing voices.

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Why Germans are federalists

May 3rd 2001 | BERLIN
From The Economist print edition

WHAT do Germans mean by a “more federal” European Union? In centralised countries like France and Britain, the words suggest a super-state grabbing ever more power from its constituent parts. In Germany, with its 16 semi-autonomous *Länder* (states), just the opposite: less centralism, not more. Indeed, many of the *Länder* are already worried by what Edmund Stoiber, the premier of Bavaria, calls “creeping centralisation by Brussels”.

Reuters

Stoiber’s brew, as Bavarian as it’s German

Most of the *Länder*, though they have existed in their present form only since the second world war, go much farther back. In the Middle Ages, today’s Germany was made up of scores of kingdoms, principalities, cities and states. At the time of unification in 1871, there were still some 25 more-or-less self-governing entities, each with its own legal and political systems.

Today, each *Land* has its own constitution, government and legislature, and wide powers, granted originally under West Germany’s Basic Law of 1949, for all matters other than those specifically assigned to the federal government: the local judiciary, police, education, agriculture, tax collection, culture, the electoral system and regional development. Each *Land* chooses its own school system and sets its own *Abitur*, the school-leaving examination and key to university entry. Each even selects its own public holidays.

Varying in size from the city-state of Bremen, with 670,000 people, to North Rhine-Westphalia, whose population of 18m would make it the fifth-biggest country in the EU, the *Länder* are represented at national level by the Bundesrat, the second chamber of parliament. Members are appointed by the *Land* governments from within their own ranks. Though big states have more seats than small ones, the allocation favours the tiddlers; Bremen, for example, gets three to North Rhine-Westphalia’s six. Chancellor Gerhard Schröder wants a similar second chamber at the EU, to represent the governments of its members.

Through the Bundesrat, the *Länder* can review, amend or even block any federal legislation that is deemed to affect their interests, particularly on tax. Though they have hardly any tax-raising powers, they are entitled to around half of all value-added tax, income and corporate taxes collected within their territory, subject to a revenue-sharing system under which DM16 billion ($7 billion) was transferred last year from the five richest *Länder* to the 11 poorer ones. Put together, their budgets added up to nearly DM500 billion, about as much as the federal budget.

The federal government has overall authority over taxation, foreign policy and defence, currency and civil and criminal law. It also has power over all matters deemed in need of uniform rules across the country. But the *Land* premiers and ministers meet regularly to co-ordinate their affairs; federal officials may attend their gatherings, but have no vote.

Any *Land* can make its own agreements with foreign countries, subject to the federal government’s consent. Each can negotiate with the European Commission on matters directly touching its interests, such as the row about subsidies to *Land* banks, which the commission wants to curb.

All *Land* governments are fiercely jealous of their powers. In the approach to last December’s EU summit in Nice, Mr Stoiber threatened to block in the Bundesrat whatever treaty emerged unless Mr Schröder won a promise from his European partners that yet another treaty would lay down clear limits to the Union’s powers. He did, and Mr Stoiber has withdrawn his threat. Plainly the *Land* premiers are holding the federal chancellor to his word.

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Sweden

In and out

May 3rd 2001 | STOCKHOLM
From The Economist print edition

WHEN Flurim Krasnici, a Bosnian asylum-seeker, received a summons from Sweden's state migration board to discuss a putative job offer, he could scarcely wait to turn up. He had recently been told that he and his young family were not entitled to stay in Sweden. Now his luck had turned. It had not: when Mr Krasnici arrived for the meeting in February he was greeted not by immigration officials but by police.

He was arrested, taken away and put on a flight to Bosnia's capital, Sarajevo. On arrival he was dispatched to Kosovo, which refused him entry and sent him on to Macedonia. His worried wife, still in Sweden with their two sons, has not heard from him since.

The sort of entrapment tactics used against Mr Krasnici have apparently been employed several times since by migration-board officials and police. On April 27th, the victim was a 28-year-old man from Kosovo who had been in hiding after having his asylum request rejected.

The incidents have provoked uproar in a country that, until recently at least, was regarded as operating one of the world's most liberal asylum regimes. Opposition politicians, church leaders and non-governmental organisations have demanded an urgent inquiry into procedures at the migration board. The use of subterfuge is not only reprehensible, they say, but liable to destroy any confidence in officialdom that asylum-seekers may have, pushing more to join the 2,000-odd already reckoned to be hiding.

Lena Häll Eriksson, head of the migration board, admits the revelations are "unfortunate". But she insists that the board is obliged to assist the police in their job of deporting asylum-seekers denied residence, though the extent of that assistance is a "grey area" and is now being reviewed.

Immigrant and refugee groups suggest the affair illustrates a hardening of asylum policy since Sweden joined the European Union in 1995, even though accepted asylum claims actually rose in the first four years of EU membership, chiefly because of an influx of refugees from ex-Yugoslavia.

Seen over a longer period, however, Sweden's readiness to let people in has indeed lessened. Its generous laws resulted in about 80% of claimants being allowed to stay during the 1970s and 1980s. From 1990 that figure dropped to 40%, after the stricter asylum criteria that apply today were adopted.

The tougher rules have not deterred new applicants: asylum claims rose by 45% last year to 16,000. Swedish officials say that organised asylum traffic and human smuggling by racketeers has bumped up the figures—which does not make any easier the work of the individuals and groups that stand up for refugees and their rights.

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Charlemagne

Frits Bolkestein, an almost sceptical EU commissioner

May 3rd 2001
From The Economist print edition

IS IT possible to be both a Eurosceptic and a powerful member of the European Commission? If anyone can put that question to the test, it will probably be Frits Bolkestein, the Dutchman entrusted with the job of running the European Union's policies on the internal market and taxation.

To be honest, it is only by the fervently committed standards of Brussels that Mr Bolkestein ranks as even a mild Eurosceptic. On most aspects of the "European project" he is a firm believer. He has no doubts about the wisdom of adopting the euro, the EU's single currency. He is a firm advocate of enlarging the Union to include the countries of Central and Eastern Europe. He argues that closer European integration has led to stronger economic growth. He has pushed for the harmonisation of indirect taxes. And he is a zealous enforcer of the rules of Europe's single market. Indeed, to the national governments that he harries into obeying European law on the internal market, he must come across as the very epitome of the bossy Brussels bureaucrat. On his own estimate, Mr Bolkestein issues no fewer than ten "infringement proceedings" against national governments each week.

For all that, Mr Bolkestein shows an unusual willingness to be rude about some of the more ambitious visions of Europe currently doing the rounds, such as the one outlined this week by Germany's ruling Social Democrats. The commissioner is openly critical of the federalist vision. "It would be a risky business to work towards a federal Europe," he said in a recent speech, "since there is a good chance of failure, and Europe might then end up on the road to disintegration as a kind of reaction."

Failure? Disintegration? These words are not meant to cross the lips of a "good European". If you want to get easy applause in Brussels, the correct attitude to adopt is "full steam ahead to European unity, and damn the torpedoes". In the same speech, Mr Bolkestein was also willing to transgress the unwritten rule that you do not make rude-sounding comments about EU countries. The most ardent federalists, he remarked pointedly, came from countries like Germany, Italy and Belgium with a "nation problem". Told that his views raised eyebrows among some of his colleagues, Mr Bolkestein shrugs and says, "It happens to be what I believe."

The commissioner's views on the political future of the EU matter because he is in charge of one of the portfolios that would be central to any further integrationist drive—taxation. The German government's new policy paper speaks of the need for "more energetic harmonisation of fiscal policy, especially with regard to taxes on business". Both the French and the Italian governments have also revived the push for a minimum level of corporate taxation, arguing that such a change is necessary to prevent EU countries undercutting each other. Mr Bolkestein, however, says he is not interested. "I don't want to harmonise corporate or income tax rates in any way," he declares. "The Irish, as far as I'm concerned, are safe in their insistence on a 12.5% corporate tax rate."

What about the often-heard argument that, without a minimum corporate tax rate, there will be a "race to the bottom" that undermines welfare systems? Again, Mr Bolkestein's response is robust. "There is absolutely no sign of that," he says, pointing out that over the past generation corporate tax receipts in the EU have gone up substantially as a proportion of GDP. Anyway, he argues, "our lords and masters [Europe's political leaders] say they want taxes to come down." In Mr Bolkestein's view the real tax problem for the EU is not that corporate tax levels are too low, but that taxes on labour are too high. And the answer to that, he says, is not tax harmonisation but reform of the welfare state.

Tax harmonisers, however, have another argument up their sleeves. They claim that the advent of a single currency makes the creation of an economic government for Europe inevitable. Mr Bolkestein

disagrees, rejecting the idea that the euro will inevitably require ever closer co-ordination of fiscal policy. “The euro can function well if we just stick to the current rules, in particular on budget deficits.”

He argues that the real test for the euro will come in about a decade’s time, when the baby-boom generation begins to retire. With huge unfunded pension liabilities, European governments will struggle to keep their budget deficits within the limits they agreed to when they joined the euro. Once again, however, Mr Bolkestein believes that the solution has more to do with welfare reform than with tax harmonisation.

These arguments may sound a bit academic. They are, however, deeply political. Mr Bolkestein’s position will undoubtedly irritate the powerful camp in the EU that is calling for more tax harmonisation, deeper political integration and a more developed European “social model”. Refreshingly, the commissioner appears not to care all that much.

Indeed, he has a certain taste for intellectual controversy. He still recalls with relish the public debates he held with Noam Chomsky, a left-wing American academic, when Mr Bolkestein was the Dutch defence minister in the late 1980s. And the commissioner says he is looking forward to another public debate with Danny Cohn-Bendit, a member (for the French Greens) of the European Parliament who leapt on to the barricades back in 1968. The pair will argue about the legacy—an economically and politically damaging one, in Mr Bolkestein’s view—of that attempted revolution.

Mr Bolkestein’s willingness to take unorthodox stands may stem from the fact his is an uncommon breed in the Brussels hierarchy. Unlike most of his colleagues in the commission, who come from bureaucratic and political backgrounds, he spent the first part of his career working for a multinational company, Shell. He went to university in the United States, and worked for long periods in Africa. He is no “little European”. And, unusually in a city where political discussion is dominated by Christian and Social Democrats, Mr Bolkestein is a fully-fledged economic liberal. That makes his an interesting voice—if still a rather rare one in Brussels.

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Unfit to write about Italy?

May 3rd 2001
From The Economist print edition

OUR editorial and investigative articles published last week, which suggested that Silvio Berlusconi's legal problems and business background made him unfit to run his country, set off a huge furore across Italy. Indeed, they provided the main point of public debate during the past week and prompted a string of articles in publications elsewhere in Europe. France's leading (and left-leaning) daily, *Le Monde*, piled in behind *The Economist*. So did *El Mundo*, a right-wing Spanish newspaper that castigated Mr Berlusconi for the way he has been handling the finances of a television company he part-owns in Spain.

Media outlets friendly to Mr Berlusconi, most patently those he or his family owns, were outraged. The magnate himself denounced our findings as "pure garbage", though he had declined to answer more than 50 questions we had sent him before publication. His Fininvest holding company said it would sue for defamation.

Many articles in this camp denounced *The Economist* as part of a "communist plot" to do him down. A leading adviser to Gianfranco Fini, the post-fascist leader whose party is allied to Mr Berlusconi's, said *The Economist* spoke for "Trotskyite minorities". Many of Mr Berlusconi's supporters accused Tana de Zulueta, who used to be our Rome correspondent until she stood (successfully) as a centre-left Olive Tree candidate for the Senate in 1996, of instigating the supposed plot. In fact, she has had nothing to do with any articles published by us since then.

The leading daily owned by Mr Berlusconi, *il Giornale*, has heaped a diet of abuse on us. On April 30th, it claimed, erroneously, that the Pearson Group, which owns a slice of *El Mundo* and the whole of the *Financial Times* (of London), which in turn owns half of *The Economist*, is bent on buying Mediaset, the company embracing Mr Berlusconi's television empire.

No less predictably, the left-wing press, notably *La Repubblica*, a Rome daily which backs the ruling centre-left coalition and is owned partly by one of Mr Berlusconi's bitterest business and political rivals, Carlo De Benedetti, was full of praise. It gave *The Economist*'s articles front-page billing on April 27th and packed some seven further pages with excerpts and related articles.

More revealing, however, was the more awkward and equivocal reaction of newspapers closer to the centre, reflecting the reluctance of many commentators and interest groups to incur Mr Berlusconi's wrath, in the expectation that he will win. A daily close to the Vatican, *Avvenire*, was studiously neutral. Italy's leading business daily, *Il Sole 24 Ore*, which is owned by Confindustria, the businessmen's association, was strikingly reticent in its coverage of the row. *La Stampa*, a Turin-based daily owned by the Fiat group (itself controlled by the Agnelli family, which usually gets along with whoever runs Italy), commented cautiously and variously.

Corriere della Sera, which is perhaps closest among big Italian publications to being independent, evinced a mixed but on the whole warily supportive reaction. One front-page editorial said Mr Berlusconi should answer the questions raised. But another of its leading commentators accused *The Economist* of betraying "ethnic prejudice" against Italy. Another said that we had underestimated Italy's need for a break with the parties of the past—and how the relative novelty of Mr Berlusconi appealed to Italians. The *Corriere*'s oldest and perhaps most admired commentator, Indro Montanelli, 92, praised us—not in his column, but on television.

The most notable feature was how seriously Italians take the foreign press—yet how ready many of them are to see a "hidden hand" guiding some plot behind whatever newspapers publish. That, sadly, is because their own press is viewed by most Italians as almost entirely *parti pris*, Mr Berlusconi's legal tribulations being assessed almost entirely along ideological rather than factual lines; and because personal patronage and intrigue among interest groups, rather than policies, are what drives much of Italian politics.

"Yes, in Italy we've got problems—it's odd that we get to find out about them from *The Economist*," says Giuliano Amato, the outgoing prime minister, his tongue only half in cheek.

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Ukraine

Hopes depart, worries return

May 3rd 2001 | KIEV
From The Economist print edition

The departure of the most reform-minded government in Ukraine's history is bad enough. The manner of its going is even worse. And the prospects for anything better are dire

THE government of Ukraine's prime minister, Viktor Yushchenko, which managed not quite 16 months before it was voted out of office last week, had reawakened hopes that Ukraine was ending a decade of misrule. The economy grew; the government paid its debts at home and abroad. There was at least the semblance of reform of the energy market, under a deputy prime minister, Yulia Timoshenko, who until recently had herself been a fuel tycoon. Mr Yushchenko was by far the most popular politician in the country, his style of government far more open and democratic than his predecessors'.

Reuters

Yushchenko´s out

Its successes counted for little among the people who matter, though. There were constant attacks from President Leonid Kuchma and his pals. These stemmed partly from jealousy, partly from annoyance that the government was upsetting lucrative business arrangements. Mr Yushchenko defended himself ably against some charges, such as ethnic slurs against his American-born wife, but much less well against others, chiefly that the central bank, when he ran it, had misled the IMF about Ukraine's reserves.

Other criticism mars his more recent record too. He himself was notoriously disorganised and unpunctual. His cabinet was incessantly tied up in crisis management; rarely was it able to plan far ahead. A banker with a marked dislike of party politics, Mr Yushchenko was surprisingly good at getting along with ordinary Ukrainians; less good at talking to small businessmen; and very bad at sweet-talking the tycoons' clans represented in parliament.

His biggest political mistake was in March, when he signed a strongly worded joint letter with Mr Kuchma describing opposition protesters, most of them his natural allies, as "fascist hooligans". That, he believed, was the price he had to pay to stay in office and safeguard the country's economic recovery. But a month later, Mr Kuchma gave him only the limpest support as his government, and Ukraine's chance of reform and stability, went down in flames.

The dwindling band of Ukraine's optimists still rest their hopes chiefly on Mr Yushchenko's beefy shoulders. If he commits himself firmly to the opposition cause, he could help create a formidable challenge to the powers-that-be, starting with a referendum demanding Mr Kuchma's resignation. The rich, wily Mrs Timoshenko backs her former boss strongly for the presidency, for which an election is due in 2003. She herself has her eye on his old job, assuming that she can stay out of the jail cell to which Mr Kuchma's prosecutors are trying to return her. She spent several weeks there earlier this year.

But the signs are discouraging. The opposition is a mixed lot, including thuggish skinheads, old-fashioned nationalists, human-rights activists, liberal democrats, socialists and Mrs Timoshenko. Though furious at his betrayal by Mr Kuchma, Mr Yushchenko, a stolid, careful man, is understandably hesitant about hitching himself too firmly to a wagon drawn by such a varied bunch. In addition, the official media are against him. As prime minister, he was guaranteed at least some air time; in opposition it will be different. The state-controlled television, easily the most important media outlet in Ukraine, can either ignore him—or blacken his name by foul means or fair.

It may not stop there. Ukraine's recent political history is dotted with corpses, including Mr Yushchenko's much-liked predecessor and mentor at the national bank, Vadim Hetman, who was assassinated after treading on some important toes. Mr Yushchenko's friends fear for his safety.

With or without him, there is too little active public support to give the opposition real clout. The

demonstrations of recent months have been huge by Ukraine's feeble standards. But even a crowd of 20,000 is unlikely to make the authorities tremble. Most Ukrainians, if they bother about politics at all, think that Mr Yushchenko is a good man but see nothing they can do to help him.

The truth is that the tycoons and hard men around the president have the guns, the money and the muscle they need to keep the wealth and power they have collared. And Ukrainians who oppose them lack the willpower, the guile and the popular backing to chase them out.

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Calculated killing in Macedonia

May 3rd 2001 | SKOPJE
From The Economist print edition

Get article background

AT THE end of March, as a burst of fighting between Macedonian security forces and Albanian-nationalist rebels was dying down, the country's leading ethnic-Albanian politician, Arben Xhaferi, made a forecast: shooting would restart in four weeks unless progress were made towards righting his community's grievances. He was correct.

On April 28th, in the bloodiest single incident in this conflict, eight Macedonians—four policemen and as many commandos—were shot dead near the border with Kosovo. On May 1st, after four of the victims had been buried in their home town of Bitola, local Slav Macedonians went on the rampage, burning some 40 shops owned by Albanians. Two days later, two more soldiers were killed in a northern village.

The riots marked a troubling deterioration. Most of the earlier violence between Slavs and Albanians had been on remote northern hillsides, not in the middle of southern towns like Bitola, near Greece.

The rebels' onslaught was almost certainly a message of sorts to local politicians and western policymakers as their efforts to fix a new bargain between Macedonia's rival communities moved up a gear. Macedonia's President Boris Trajkovski was about to visit Washington, and quiet but intensive mediation by the European Union's foreign-policy chief, Javier Solana, and the American State Department was yielding progress.

If those efforts do succeed, the government of Macedonia could be entrusted to a sort of rainbow coalition, including the Slav and Albanian parties that are already in government and their main rivals. This administration would have the moral authority to change the political system, in ways designed to reassure the Albanians, and lead the country into elections this autumn. Or so the theory goes.

On the mildest interpretation, the rebels' latest attacks were a bid by ethnic-Albanian hardliners to boost their side's position in coming negotiations; a darker view is that their self-described National Liberation Army wants to wreck all prospects of a settlement that would leave extremists isolated and bolster moderates.

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Italy

But what about their policies?

May 3rd 2001 | FLORENCE
From The Economist print edition

Amid the furore over allegations against the leader of the right, Silvio Berlusconi, policy differences between the main groups risk being forgotten—perhaps because they are for the most part fairly small

A PICTURE is worth a thousand words, they say, which may be one reason why Italy's right-wing coalition, known as the House of Freedoms, is banking on a 128-page photograph album featuring its leader, Silvio Berlusconi, the country's richest man, who has promised every Italian household a copy before the general election on May 13th. The coalition of the ruling left, the Olive Tree, takes another tack. Its manifesto, about as long as Mr Berlusconi's picture book, has just one small photograph of its leader, Francesco Rutelli, a former mayor of Rome, who says he believes in the power of words.

AP

Rutelli says he's got the answers

Indeed, it is the **style** of the two campaigns that has been most strikingly at odds. Mr Berlusconi seeks a personal vote of confidence from the voters. The left has been more restrained in parading its standard-bearer: it accuses Mr Berlusconi's own Forza Italia party of building a cult of personality round its leader.

In fact, both the main coalitions' programmes are quite alike, especially on **economics**. Both promise to lighten the weight of government. The left, which has cut quite a bit of the red tape that Italians complain about so vociferously, says it will halve the number of ministries from 24 to 12. The right promises to cut in half the number of people in parliament. Across the spectrum, all politicians say they will replace a jungle of legislation with a simpler body of laws. Mr Rutelli says that at least 12,000 of them should be abrogated; Mr Berlusconi insists that his government would match such moves.

Both agree that Italy's **constitution** needs reforming, though attempts to do so in the outgoing parliament were dished by Mr Berlusconi. He argues that Italy's head of state should be directly elected.

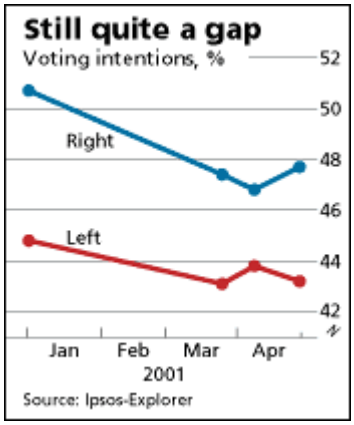
Both coalitions promise, as virtually all parties always do, to attend to the woes of Italy's Mezzogiorno, **the south**, where a fifth of the workforce (twice the national average) have no jobs. Mr Berlusconi hails his plan for the south as the key to Italy's development as a whole. He wants to offer incentives to help farming and tourism there; business will get tax breaks for investing; quantities of cash will help the sagging infrastructure.

Mr Rutelli stresses his determination to clean up local government in the south. But he too says his government would invest heavily in the south's infrastructure. Both coalitions say they will ensure that a bridge will be built between Sicily and the mainland—a project that has been in the air for decades.

Even the two groups' promises on **tax** are fairly similar. Both say they will cut it. Mr Berlusconi says he will bring corporate tax and the top level of income tax down to 33%, albeit gradually. He has promised to abolish taxes on gifts and inheritance, and will exempt reinvested profits. He also promises families with annual incomes of less than 22m lire (about $10,000) that they will pay no tax at all. Mr Rutelli puts the threshold for paying tax a bit lower, at 20m lire. He too promises lower business taxes.

In any event, whichever coalition forms a government will have its hands tied by the European Union's stability pact that limits, among other things, the size of the public deficit. Mr Berlusconi's plans sound more extravagant than

Mr Rutelli's, though Forza Italia's would-be treasury minister, Giulio Tremonti, has sought to reassure businessmen that election hyperbole will give way to more sober action once his team is in office.



The left, however, boasts that its three prime ministers since 1996 all managed, as few of their predecessors have, to squeeze the deficit and improve budgetary discipline—with the triumphant result that Italy joined the euro-zone at the outset. Mr Rutelli also promises to speed up liberalisation and to sell off what is left of the state's holdings. The right promises the same.

Reform of pensions, though hugely necessary, is definitely not an election-winner. Earlier this year, Mr Berlusconi promised that pension rights would not be touched. The second of the three main parties in his coalition, the post-fascist National Alliance, is notably reluctant to offend its many public-sector supporters. The left sounds readier to tackle the pensions issue, but has certainly not raised it with zeal.

On **foreign policy**, the tone of the two coalitions' views is certainly different, the content less so. Mr Rutelli's manifesto is more eagerly internationalist; it sounds warmer towards international bodies such as the UN, the OECD and even NATO. The right generally echoes the left's enthusiasm to integrate Italy more tightly within the EU, but sounds more nationalist. The left makes much of Mr Berlusconi's judicial problems, portraying him as unable to walk tall abroad.

The clearest difference between the two coalitions may be in **social** attitudes. The Olive Tree is liberal, secular and tinged with the left's historic animosity to the Vatican's influence on politics. It opposes the right's plan for school vouchers that would enable more children to attend church-run schools. The left favours genetic research on embryos; the right says it would make it harder for women to have abortions.

Perhaps the most emotional issue dividing left and right is that of **illegal immigration**. Both sides are against it. But the right sounds much fiercer towards the illegals, tagging them with **crime** and demanding harsher measures against them and more peremptory expulsion. Mr Berlusconi's coalition ally Umberto Bossi, of the once-separatist Northern League, sounds particularly harsh towards immigrants in general. If the right does win, as the opinion polls still suggest it will, this issue might be the clincher.

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Plagued by race

May 3rd 2001
From The Economist print edition

Mr Hague's attempt to discipline his party has exposed the flaws in his leadership at a terrible moment: the eve of a general election

Get article background

WHEN the leader of a political party summons the cameras to the front door of his head office in order to jut his chin, stamp his foot and declare that he is the fellow in charge, you know that he is in serious trouble. So it was this week, when William Hague appeared on the doorstep of Conservative Central Office brandishing the apology he had at last wrung out of John Townend. The retiring backbencher was apparently "very sorry" that his "offensive" and "ill-chosen" words on race and immigration had given the impression that Conservatives were racist. He promised to shut up. But the promise came too late to undo the damage to Mr Hague. More than ever, and worse on the eve of an election, the Conservative leader looks like the weak leader of a divided party.

Mr Townend has never been a force in Conservative politics. After more than two decades as a passed-over backbencher, he will not be standing in the election Tony Blair is expected to announce next week. He is only one of several Conservative MPs who have refused to sign an "election compact", published by the government-financed Commission for Racial Equality (CRE), in which the leaders of the main parties promised not to stir up racial hostility in the coming election. He attracted attention mainly because he accompanied his refusal with a sequence of increasingly provocative remarks about race. And these caused a storm only because Mr Hague consistently fluffed his response to them.

Totally unacceptable

The sequence began in March, when Mr Townend said that Britain's "homogenous Anglo-Saxon culture" had been undermined by immigration. In April, a Labour cabinet minister hit back. Using Mr Townend's views as a rod to beat the whole Conservative Party, Robin Cook, the foreign secretary, called talk of a homogenous Anglo-Saxon society a "pitiful" misreading of history: the British, he said, had never been a race but were a "gathering of countless races and communities". Mr Townend, thus goaded, accused Mr Cook of insulting his Yorkshire constituents by calling them members of "a mongrel race". From the second generation, he said, all immigrants should consider themselves natives of Britain "rather than looking back to a motherland abroad". And that meant adopting the English language and culture.

At every point in these exchanges, Mr Hague has admonished his wayward backbencher. When Mr Townend said that immigrants undermined Britain's homogenous culture, Mr Hague called these remarks "totally unacceptable". When Mr Townend talked of "a mongrel race", Mr Hague said that, on the contrary, multiculturalism was one of Britain's strengths. But Mr Hague refused to expel him. The man was retiring anyway, said Mr Hague, so expelling him would be just "gesture politics". To do so, added Liam Fox, the Tories' health spokesman, was to risk turning him into a "martyr".

That, at any rate, was the line at the end of last week. By the start of this one, the intervention of Lord Taylor of Warwick, a black Conservative in the House of Lords, had forced an abrupt change. In 1992, as plain John Taylor, Lord Taylor had stood as the Tory candidate for Cheltenham, which is normally a safe Conservative seat when the candidate is white. It rejected him. He now declared that even the broad church of the Conservative Party could not contain both Mr Townend and "people like me".

This strong hint that Lord Taylor might resign from the party—or, worse, defect to Labour—persuaded Mr Hague to tell Mr Townend that he would be expelled if he repeated his "intemperate" remarks about race. But Lord Taylor was far from impressed. Instead, he wrote a withering article for the *Times* in which he called the yellow card Mr Hague had shown belatedly to Mr Townend the "pathetic" response of a weak leader. Mr Hague should have withdrawn the whip from Mr Townend when his initial attack on multiracial Britain was first reported: "Mr Hague is desperately trying to bury the race issue," he said. "In all probability, the race issue will end up burying his leadership."

Pathetic

And so, on April 30th, to the doorstep of Central Office, the stamping of Mr Hague's foot, and the strong leader's insistence that the Conservative Party was not racist. To prove it, he had extracted an apology and vow of silence from Mr Townend. But nor could a strong leader let a Conservative peer "agonise publicly" about whether he still supported the party. For that reason, Lord Taylor would be asked to add his name to an open letter from black and brown Conservative politicians reaffirming their loyalty.

Lord Taylor has said that he is satisfied, for now. But he might still defect. Some Tories claimed to see the hand of Alastair Campbell, Tony Blair's official spokesman and unofficial Machiavelli, in Lord Taylor's manoeuvres. But even if he does stay in the party, Lord Taylor has caused Mr Hague lasting damage by branding his leadership on the race issue pathetic.

Has it been? Mr Hague is guilty, at a minimum, of crossing his wires. He signed the CRE's election compact on race without foreseeing that some MPs might refuse to sign it, or working out what he would then do. The result was a circus. The party leader signs the solemn pledge; an obscure backbencher wins massive publicity by refusing to sign; Michael Portillo, the shadow chancellor, says he will not sign because it does not take a piece of paper to show that he is no racist; Ann Widdecombe, the shadow home secretary, calls the pledge "silly" but signs anyway, so that people cannot call her a racist when she continues her crusade against "bogus" asylum-seekers.

Too many cracks

Mr Hague is also guilty of indecision. Having crossed his wires, why did he not uncross them by taking stronger and earlier action against Mr Townend? His own explanation—a dislike of "gesture politics"—is hard to take seriously. Since when did a politician shrink from gestures? A likelier reason was Mr Hague's fear that expelling Mr Townend would prompt like-minded Conservatives to rally at once to the sacked man's defence, and so create a public rift between left and right inside the party.

The trouble is, the cracks are showing anyway. The day after Mr Hague wrung the apology out of Mr Townend, he had to extract a similar one from Laurence Robertson, the Conservative MP for Tewkesbury, who thought for a moment on television that he had found some virtue in Mr Townend's views. The party's elder statesmen have also been aroused, and will prove harder to silence. From the right, Lord Tebbit, inventor of the "cricket test" (all immigrants, he once said, should cheer the England team), declared this week that he knew of no happy multicultural society. From the left, Sir Edward Heath, a former prime minister, accused Mr Hague of moving the party to the "extreme right". He contrasted Mr Hague's vacillation with his own swift eviction of Enoch Powell from the shadow cabinet 33 years ago for the infamous "rivers of blood" diatribe against immigration.

Mr Hague has long denied moving his party to the right. Having made many speeches in favour of ethnic tolerance, he insists that his party should be allowed to argue against the abuse of the asylum system without being accused of racism, just as it should be allowed to oppose British membership of the euro without being accused of seeking to quit the European Union. And so it should. But these are difficult messages to convey. In both cases they are complicated by the Conservatives' past form and present divisions, which Labour and the Liberal Democrats are understandably eager to exploit. Explaining them to voters will require cleverer leadership than Mr Hague has managed to show these past two dismal weeks.

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The economy

Labour's coup

May 3rd 2001
From The Economist print edition

Four years ago, the Bank of England was set free to control inflation. So far, so good but it has not yet been seriously tested

CONDUCTED with the lightning speed of a military coup, the first initiative of the new Labour government was also its most important. The decision to make the Bank of England independent, announced within days of taking office in May 1997, stunned supporters and opponents alike. Now, as Labour prepares for election, it forms a central part of its economic record.

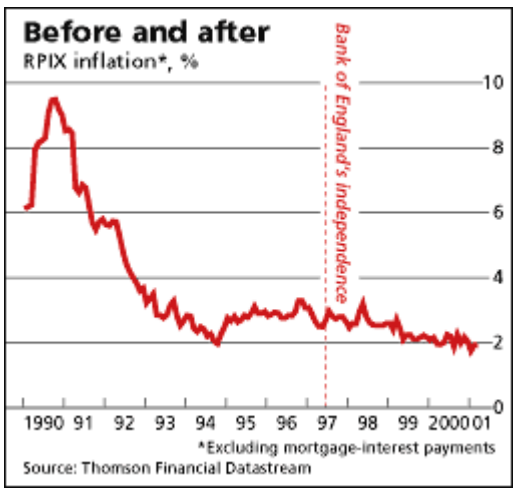
Although the reform was unexpected from a party that had nationalised the Bank in 1946, it gave less independence than many other central banks enjoy. For one thing, the government retained control over the goal for inflation, confirmed this week by Gordon Brown, the chancellor of the exchequer, at 2.5% a year. By contrast, the European Central Bank sets its own inflation objective. For another, the chancellor directly appoints four members of the Bank's nine-strong Monetary Policy Committee (MPC) which sets interest rates.

Asked about the impact of the French revolution, Zhou Enlai, China's premier under Mao, said it was too soon to tell. A mere four years since Gordon Brown's reform, the same caveat arguably holds true for the decision to restore operational independence to the 300-year-old Bank. That has not stopped people from reaching a favourable interim judgment. Sir Alan Budd, a former member of the MPC, has called the new framework excellent, "possibly the best system in the world for setting monetary policy". Lars Svensson, an economist at Stockholm University, cites the Bank as an example of "best international practice".

But then it would be difficult to find serious fault with the Bank when inflation has hovered around or below target over the past four years while the economy has continued to grow robustly and unemployment has fallen. The black spot has been manufacturing, which has suffered from the strength of the pound, although this has largely reflected the general weakness of the euro.

So how much credit can the Bank claim for Britain's inflation performance? Some—but not all. Since June 1997, inflation has averaged 2.4%. However, in the previous four years, the 12-month average was 2.7%. Look at the chart and without prior knowledge you would be hard pressed to infer that the Bank started to set interest rates independently in June 1997. Nor should this necessarily be a surprise. Despite its drama, Mr Brown's decision followed a series of reforms starting in late 1992 that had steadily increased the effective power of the Bank.

The real break in Britain's record on inflation in the 1990s came as it was wrung out of the system, initially through targeting the exchange rate, while Britain was a member of the European exchange-rate mechanism. Indeed, the long-term reduction in inflation goes back well before then: inflation peaked at 27% in August 1975. It is not just in Britain that inflation has fallen to the lowest for a generation; it declined throughout the developed world in the 1990s. "It's quite clear that the new arrangements put a seal on low inflation rather than achieving it," says John Flemming, a former chief economic adviser to the Bank.



If claims that the reform of May 1997 has transformed the inflation outlook are overstated, so too are charges that an independent Bank has made a hash of monetary policy. Critics say that it has persistently under-shot inflation, which has now been below target for two years. This may be true, but the shortfall has been trivial. The chancellor's remit to the MPC calls for an explanatory letter if inflation rises

above 3.5% or falls below 1.5%. A decline in inflation, currently 1.9%, may shortly trigger the Bank's first letter. However, this will still be a creditable record, given the past volatility of inflation.

Certainly, the Bank's record as a newly empowered independent central bank compares favourably with that of the European Central Bank, which has demonstrated a notable lack of clarity in presenting its policy. By contrast, the Bank is now upheld as a model of transparency, a remarkable transformation for an institution long renowned for its culture of secrecy. In 1968, Roy Jenkins, then Labour chancellor, confided that "the Bank of England is a closed book to us all."

This new-found transparency has laid bare disagreements between the individual members of the MPC, who often split in the committee's votes. This in turn reflects differing views about the outlook for inflation, which has made the Bank's inflation forecast increasingly difficult to interpret. In its last *Inflation Report*, the MPC presented a forecast whose central projection showed inflation rising to 2.5% by the start of 2003. However, the report also revealed that some members thought inflation could be up to half a percentage point lower by then. In a more challenging economic environment, the muddle over the forecast would matter more. As Mr Flemming says, "The new system has been working but it has not been fully tested."

A related concern—since dissenting voices have primarily been the external members appointed by the chancellor—is the structure of the monetary policy committee. Despite his praise for the Bank, Mr Svensson says there are several problems with the committee as it stands. It is "unnecessarily large" and the three-year terms of the external members are too short. He is also unimpressed by the chancellor's role in appointing the outsiders. In a recent review of New Zealand's monetary arrangements, he recommended that committee members, other than the governor, should be appointed by the central bank's board. The equivalent body for the Bank would be the non-executive members of its "court" of directors.

In his "Wealth of Nations", Adam Smith said that the Bank of England acted "not only as an ordinary bank but as a great engine of state". Lord North, the prime minister who lost the American colonies, declared in 1781 that the Bank "from long habit and the usage of many years was a part of the constitution". But for the past half-century, the Bank had lost its own empire and lacked a clear role. Now it has one. So far, it has performed well. But it has not yet faced the storms that would test whether it has once again secured its place as "a great engine of state" within a modern constitution.

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Countryside

After foot and mouth

May 3rd 2001
From The Economist print edition

Foot-and-mouth disease is on the wane, but not the debate over the future of the countryside

THE government was roundly condemned only six weeks ago for saying that the outbreak of foot-and-mouth disease (FMD) was "under control". Now, that claim is hardly disputed. At its peak, 30 or 40 new cases were being reported daily; now, the numbers are down to three or four. On May 3rd the prime minister declared the crisis was at an end.

AP

Life's good

Britain's countryside has not yet returned to normal. More than 80% of the country's footpaths remain closed. But at least farmers are beginning to see the end of their nightmare. The cost of the outbreak has been high. Last week, the Centre for Economic and Business Research estimated that the epidemic would cost farmers £3.6 billion ($5.2 billion). The government estimates that tourism is still losing £125m a week, and the British Tourist Authority (BTA) says that on current trends Britain could lose up to £2.5 billion over the year in revenue from overseas tourists. The chief executive of the BTA, Jeff Hamblin, argues that it may take up to three years for the industry to recover and for overseas tourists to return in strength.

So far, nearly 3m animals have been slaughtered. The effect of the trauma that farmers have been going through is illustrated by a recent survey in *Farmer's Weekly*. Of 100 farmers questioned by the magazine, a third planned to restock their farms only partially. Moreover, 6% of farmers expect to leave the business altogether, three times the normal yearly average.

Even before the outbreak of FMD, the countryside was in trouble. Agricultural incomes had declined steeply. Tony Blair's determination to press ahead with the ban on hunting had inflamed rural opinion. The crisis may have squeezed out discussion on all other countryside issues but with its end in sight, the nature of the debate may be about to change.

The daily sight of sheep being slaughtered and the burning pyres has heightened public awareness of countryside issues. Michael Winter, professor of the rural economy at Cheltenham and Gloucester College, argues that the crisis has emphasised the "strong links" between agriculture and other sectors of the rural economy, such as tourism. He believes that it will never again be possible to discount the contribution of agriculture, as some had been tempted to do because of the falls in farm incomes.

The main long-term casualty of FMD looks like being the much maligned Ministry of Agriculture, Fisheries and Food (MAFF) itself. The ministry has been strongly criticised for responding too slowly to the crisis. But long before FMD came along, critics such as the Countryside Alliance (CA), the main lobbying group on countryside issues, argued that MAFF was too narrowly focused on helping farmers win subsidies for agriculture production to care much about the wider effects of that policy on the countryside. This week, even Nick Brown, the agriculture minister, echoed the CA's call for the creation of a new Department of Rural Affairs.

Some agricultural practices will have to change. The use of waste meat in pig swill will be completely banned. And there will be great pressure on the government to encourage more abattoirs to open and thus reduce the need to transport livestock so many miles around the country. Transporting animals was an important reason why FMD spread so quickly.

Those who oppose a ban on fox-hunting also believe the disease has changed the debate. The Countryside Alliance claims that, for the first time in the three years of its existence, membership rose over the winter by about 10% as more people have sympathised with the plight of those living and

working in the country. The latest poll taken for the CA shows that now only 37% of respondents support a total ban on hunting, accelerating a downward trend from 76% in 1997.

Lady Mallalieu, a Labour peer and chairman of the Leave Country Sports Alone campaign, argues that the crisis has proved what an invaluable contribution the hunting community makes to the countryside as a whole. She is probably right in her assessment that it may be harder for a re-elected Labour government to press ahead with its plans to abolish fox-hunting.

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Bagehot

The trouble with Liberals

May 3rd 2001
From The Economist print edition

Get article background

POWER corrupts, said Lord Acton, a Liberal peer. But loss of power, said somebody else who might as well have been talking about a Liberal, tends to corrupt absolutely. This is a motto that Charles Kennedy, the leader of the Liberal Democrats, may want to bear in mind as the general election approaches.

Tony Blair is expected to announce next week that the election will take place on June 7th. To judge by recent polls, the Conservatives are cruising to a clobbering. Until recently, they had been adding up how many seats William Hague needs to gain in order to keep his job as their party's leader. But Mr Hague may not gain at all. A MORI poll for the *Sun* this week predicts that Labour is on course to win 443 seats, puffing up its majority from an already bloated 179 MPs in the present parliament to 227 in the next. The number of Conservative MPs will fall from 165 to 158, and the number of Liberal Democrats from 47 to 30.

That would be a dismal result for both opposition parties. But in one respect it would be worse for the Liberal Democrats than for the Conservatives. Even if the Tories ditched their leader, they would not lose hope of returning to power one day. The Lib Dems would keep their leader, but would know in their hearts that power was farther beyond their grasp than ever.

This is not the *spiel* you hear from official Lib Demmery. The official line is that the third party has never been nearer to office; that only Mr Blair's timidity, and the indecent size of Labour's majority, stopped the creation of a Lib-Lab coalition in 1997; that winning 46 seats in that election put more Liberals in the Commons than at any time since Lloyd George; that last year's by-election capture of Romsey was an earnest of victories to come; and that, all the while, the Lib Dems have been exercising real influence. They sat in on a cabinet committee, shaping Labour's constitutional reforms. They run plenty of town halls. In the new parliaments of Scotland and Wales, they rule in coalition with Labour. A few more heaves and surely there will come an election when Lib Dems hold the balance of power at Westminster and can force the Labour Party to scrap the iniquitous non-proportional voting system that has locked them out of power?

Well, it is possible. But it is growing less likely. In the euphoria after Romsey, top Lib Dems speculated that a Tory collapse could propel them as high as 100 seats. They now admit in private that they will be lucky to keep the seats they have. As MORI's poll indicates, the Tories could indeed collapse. But, contrary to what some guileless Lib Dems imagine, this would not do much good to their own party. A cull of Conservatives would push Mr Blair's majority farther into the stratosphere, making it even harder for Mr Kennedy to clinch a Lib-Lab deal on voting reform than it was for his predecessor, Paddy Ashdown, who got on better with Mr Blair.

If the immediate outlook is gloomy, what of the longer term? It is worse. The Lib Dems' strength in Parliament does not reflect their underlying voting strength. The 46 seats they won in 1997 were indeed a record, and twice the number they won in 1992. But even so the party's share of the vote, at 17.2%, fell for the fourth election in a row; and most polls suggest that it will fall again. In short, the closer you look, the farther from office this party appears.

Which brings back Lord Acton. Loss of power is a terrible thing for a political party. But losing hope in the possibility of power is worse. The question that has plagued Liberals for more than half a century is how a third party can break open a two-party system.

In the 1960s, Jo Grimond, leader of what was then simply the Liberal Party, thought he had an answer. The plan was simple, though he knew it would take time: move to the centre-left and replace Labour as the alternative to the Conservatives when class loyalties began to grow weaker and socialism lost its allure. Initially, Mr Ashdown adopted the same plan. What neither foresaw was the possibility of a Tony Blair: a politician who was not a socialist, and who despised class politics, but who nonetheless found a

way to lead the Labour Party without breaking it apart. Mr Blair has, in effect, imposed on Labour the Grimond master-plan for the Liberals.

For obvious reasons of brand differentiation, Lib Dem leaders do not endorse this version of events. Mr Blair is no liberal, splutters Mr Kennedy: just look at New Labour's authoritarian record on asylum-seekers, jury trials, civil liberty and all the rest. But although broadly right, Mr Kennedy's case against Mr Blair has two weaknesses. One is that Mr Blair is enough of a liberal to have grabbed the very role that Grimond mapped out for his own lot as the non-socialist alternative to the Conservatives. The other is that Mr Kennedy is not much of a liberal either.

The voters may not yet have noticed it—a third party must be a "centre" party, mustn't it?—but the Lib Dems have moved to the left of New Labour. Indeed, John Meadowcroft, a political scientist at London University's Queen Mary and Westfield College, argues in a recent *Political Quarterly* that they are more recognisably social democrat than liberal. They accentuate positive liberty (empowerment) over negative liberty (freedom from coercion). They call for higher taxes. Their instinct is for the state, not the preferences of consumers, to shape public services.

None of this is surprising: Mr Kennedy himself joined the Lib Dems by way of the Social Democrats, and many Lib Dem councillors have spent their political careers opposing the language of the market that they heard from the mouth of the hated Margaret Thatcher. But if there is a market opportunity in British politics, it is the absence of a party that dares to be liberal in both its economics and its social policy. This tradition, Mr Meadowcroft argues, is the Lib Dems' to reclaim. It may not win them power, but their present strategy shows few signs of doing that either. Besides, it might even be worth doing for its own sake.

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May Day follies

May 3rd 2001
From The Economist print edition

LONDON'S Metropolitan police must feel they are damned if they do and damned if they don't. During last year's May Day protest, they were criticised for allowing anarchists to deface the Cenotaph and a statue of Winston Churchill. This year they were bitterly reproached by hundreds of innocent people who were trapped for hours inside a police cordon at Oxford Circus.

Did the police over-react? It would not be entirely surprising if they did. As May Day approached, predictions about the scale of anarchy to be unleashed on the capital escalated. There would be around 1,000 hard-core troublemakers, some of them parachuted in from abroad, and others armed with samurai swords. Warnings about the Met's response escalated proportionally. The chairman of the Metropolitan Police Authority suggested rubber bullets might be used in extreme circumstances. Hundreds of shops across the West End duly boarded up their windows.

EPA

Ritual battle

Despite these forecasts, the day began peacefully, with just a few damp anti-capitalists outnumbered by both police and journalists. At a lunchtime rally at Piccadilly Circus, bemused tourists watched a gaggle of protesters play home-made musical instruments and recite appalling poetry. The only challenge on offer was to avoid being kissed by determined female fluffies, bent on spreading love and peace. But of course, real anarchists would not be out of bed yet.

Sure enough, by the beginning of the afternoon, things had turned ugly. Hundreds of police swept up Regent Street and the two sides of Oxford Street in a pincer movement, herding anyone in their way into a tight pocket of drenched, cold, hungry humanity. The police seemed unconcerned that many of those trapped were innocent bystanders, some of them tourists out to do a bit of shopping. One frightened businessman trapped inside the police lines pleaded to be arrested so that he could escape the mayhem. Eventually, the police did let some of the "reasonable" elements out, although by no means all.

The cordon round Oxford Circus was kept in place for seven hours, containing the hardcore protesters in a confined space where they could do the least damage. Sporadic violence flared up when the disgruntled protesters were released in small groups at 9pm. Overall, 65 people were arrested and 50 injured.

The trouble was just sufficient for the police to claim that their tactics had been justified. The end result, though, was probably a draw. Rioting, like crime, can indeed pay, and at times in London's history it has proved a successful sort of collective bargaining. Anti-capitalism is too wilfully disorganised a movement to change very much on its own. However, with the help of the police, it managed to close down London's central shopping precinct for a day, at an estimated cost of £20m. Not bad for a bunch of middle-class adolescents in Che Guevara T-shirts.

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Housing

Not the council's business

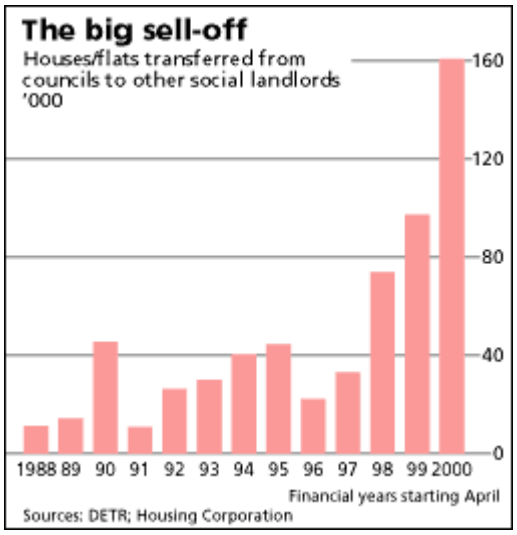
May 3rd 2001
From The Economist print edition

Some councils are getting rid of their entire housing stock

BRITAIN'S biggest sale of houses has just taken place. Some 36,800 homes valued at more than £200m were sold in one job lot. The sale did not make any headlines in the newspapers that cater for the British obsession with house prices, for these homes were all council houses in Sunderland. Yet the sale is part of as big a housing revolution as the laws passed in the 1920s that saw municipal housing providing the homes fit for the heroes returning from the battlefields of the Somme.

Social housing has been a political battleground ever since it started. Successive governments vied with each other to win votes by building houses. By 1979, Britain had about 6m council homes. The Conservatives then started selling council houses to tenants—about 2.1m have been sold in this way—and encouraging the transfer of council stock to housing associations.

The sale of council housing to other "social landlords" is now happening faster than it did under the Conservatives (see chart). These days the buyers are mostly housing associations or companies set up to own and run houses at low rents in specific areas. Usually a third of the directors are elected tenant representatives, a third local councillors, and the rest are housing and other professionals. Profits are recycled into housing improvements or the building of new houses. These new social landlords now own 1.45m homes in England. At the rate they are now buying houses, they could own more than councils will do by 2004.



The reasons for the big sell-off are not hard to find. Most towns and cities have estates as bad as the slums from which council housing was originally supposed to rescue people. Councils cannot afford to put them to rights. The government estimates that the repairs backlog in England amounts to £19 billion. Scottish and Welsh houses need another £3 billion.

If the councils borrowed the money to pay these bills, the consequent rise in public-sector borrowing would limit the government's ability to borrow money for other public services. By contrast, housing associations' borrowing counts as private-sector loans. So the government is helping make it worth the councils' while to get rid of their stock.

Even though many of the houses are in poor shape, there are plenty of willing lenders. Sunderland Housing Group, the new owner of 36,800 houses, borrowed £420m from the Royal Bank of Canada and ABN Amro, a Dutch bank. Whitefriars Housing Group, which took over Coventry's 20,169 houses last September, negotiated a £240m loan from Nationwide Building Society and the NatWest bank. Houses, to the lenders, are a secure low-risk investment.

The tenants get a good deal, too. They are guaranteed that their rents will rise by no more than inflation plus a percentage, which the government has now cut from 1% to 0.5%, for at least five years. And the housing associations and companies commit themselves to repairs and improvements that the councils never delivered. Sunderland's houses will have £1.2 billion spent on them over the next 30 years, and Coventry's tenants will get £240m spent on them over the next seven years. Most of their rights, including the right to buy, are also preserved under these sales.

Rents tend to be a bit higher—about £59 per week on average, compared with an average council rent of £46—but surveys have shown that the new social landlords' tenants feel more involved in running their

areas and more satisfied with what they get. The word is travelling. Councils are required to allow tenants a vote on a proposed transfer and, so far, three-quarters of ballots have gone in favour of a transfer. The big test of the policy will come next year when Glasgow and Birmingham try to sell their houses. Both have about 90,000 homes and have to persuade their tenants to vote for a sale.

The central government is picking up most of the tab. Most of the better houses have now been sold off, and what remains is the worse stuff. The bill for subsidising these sales will therefore increase. There are also signs that the rent rises caused by the shift in ownership are pushing up the bill for housing benefit, the rent subsidy paid to poor people. Although the number of recipients in 2001-02 is forecast to drop to 2.2m from 2.6m last year, the total bill is expected to rise from £11.7 billion to £12.4 billion. But if the bulk sales improve Britain's worst estates, it may be a price worth paying.

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Cities

Post militant

May 3rd 2001 | LIVERPOOL
From The Economist print edition

Local government is being reinvented in Liverpool

MERSEYSIDE is still living down the reputation it earned when Derek Hatton's Trotskyite militants ran Liverpool city council in the 1980s. But times, and the city's politics, have changed. Now, under Liberal Democrat control, the council is developing a reputation for improving public services while freezing local taxes.

When Mike Storey became leader of the council in 1998, he found that winning power did not mean that he had control. "You pulled a lever, and nothing happened," he says. Policies got lost in a labyrinth of committees. Officials regarded problem-solving as putting a note on a file to say they had passed it to someone else.

Mr Storey brought in management consultants. "They said that some of our officials were not only bad, but downright dangerous," he says. A new chief executive, David Henshaw, was hired on a £130,000 annual salary, then a record for local government. Mr Henshaw brought a reputation for ruthless efficiency from running neighbouring Knowsley council (where he had sacked Mr Hatton from his council job).

Mr Henshaw found he had nine deputies and 48 heads of department. He cut that to five executive directors, who have portfolios of responsibilities rather than departments. Since taking charge 18 months ago, he has also cut the council's non-teaching staff by 3,275 to 18,000. All that has been achieved without a day lost through strikes, an achievement in a city where it used to be an article of faith that the council's duty was to employ as many people as possible.

Meanwhile, Mr Storey abolished the committee system. Now, provided that there is no objection from scrutiny committees, 11 executive councillors take all the decisions apart from those on planning and licensing matters. Around 95% of decisions go through in five days without further debate. Mr Henshaw calculates that about £60m of administrative costs has been saved. This has enabled the council to put more money into education and to freeze the council-tax bills paid by Liverpudlians for three years.

The new ethos is exemplified in the council's call-centre. Instead of being passed from one telephone extension to another in search of the right official, people can telephone one person to get things done. Set up two years ago with 13 people, it has become the largest council call-centre in Britain. More than 100 staff handle 35,000 calls a week from 8am to 10pm and at weekends.

They deal with rent and council-tax inquiries and payments, rubbish and pest-control complaints, student grants and loans, tourism information, voters' registration and many other council activities. In setting this up, Mr Henshaw discovered just how bureaucratic the council was. Getting an abandoned car removed used to involve up to 11 people. Now the call-centre takes the details, checks that there is money in the budget, and orders a removal. Mr Henshaw thinks more can be done. He says data gathered about people—their likes and dislikes—could be used for "intelligence-led" services. Libraries, for example, could telephone people when their favourite author's new book is in stock. Computer systems could monitor rubbish collection, so frequent collections could be made for people with lots of rubbish, and occasional pick-ups for those with less. Not surprisingly, quite a lot of councils have been visiting Liverpool recently. So too have ministers, including John Prescott, the deputy prime minister. It is a welcome change from the days when Labour leaders used to denounce the practices of Liverpool council as obscene.

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Health

What's up, Doc?

May 3rd 2001
From The Economist print edition

Doctors seem determined to embarrass the government. Has Labour promised too much?

THERE was at least one protest on May 1st, which provoked public sympathy. Though unspectacular, it was symptomatic. The demonstrators in question were general practitioners (GPs), a few of whom downed their stethoscopes and prescription pads in anger at their lot. Such eruptions of medical disgruntlement threaten the government's ambitions for the health service.

Ministers have already alienated hospital consultants with their plans to restrict their right to practise privately—a proposal that the British Medical Association (BMA) says may be illegal. And more serious militancy than the wildcat protest on May Day is yet to come: the BMA is asking all GPs if they would consider resigning, should a new contract not be agreed with the government by next April. The ballot's result should be ready, awkwardly for the government, just in time for the election.

It wasn't supposed to be this way. Last July, Tony Blair published a ten-year master-plan for the NHS. Its aspirations ranged from reduced waiting times to improving hospital food. Dissenting voices wondered about the plan's feasibility and radicalism, but the medical professions were supportive. Yet now concerns about health care, which helped propel Labour to office at the last election, threaten to embarrass it at the forthcoming one.

In the case of GPs, the government may be more spinned against than sinning. The dissidents say that bureaucratic burdens, new political targets, rising patient expectations and evolving medical treatments are conspiring to make their jobs impossible, and to damage patient care: average time per patient is now around eight or nine minutes. Worse, retirements and inadequate recruitment will exacerbate the problem. The government's plan says it wants to recruit 2,000 more GPs for England by 2004—a target the BMA says is unlikely to be achieved and is in any case grossly inadequate. The target for consultants is 7,500. Mike Pringle, chairman of the Royal College of General Practitioners, says family doctors worry that politicians concentrate too much on "consultants, sexy new units and cardiac surgery", when the vast majority of care takes place in GPs' surgeries and patients' homes.

But as Steve Gillam, a GP and analyst at the King's Fund, a health think-tank, says, many of the problems besetting general practice are long-term. Labour has introduced "golden hellos" of £5,000 for new GPs, incentives for retiring ones to stay on, and measures to cut doctors' paper-work. Official figures suggest that GPs now undertake fewer consultations and out-of-hours visits than was the case a decade ago. As with the bust-up with consultants, some GPs view the new-style contract that the government wants them to sign as a slur on their professional integrity. But reform of their terms of service is overdue.

Ministers have earned some unpopularity by concentrating power in Whitehall, and through the relentless edicts they have issued. In his defence, Alan Milburn, the health secretary, argued last week that Labour's strategy has been to establish national standards in its first term, before devolving power in its second. To do so, and to prune NHS bureaucracy, Mr Milburn said the number of local health authorities would gradually be reduced by two-thirds; more decisions will be taken by GPs themselves, through the primary-care trusts into which they have been grouped.

However, Mr Milburn's proposals are an over-hyped re-announcement of existing policy, and should be treated sceptically. His two-term strategy looks like a belated acceptance that central diktats are not the best way to motivate professionals. Promises to cut red tape are always popular; but in reality the new arrangements will mean either that doctors do more of the paper-work they are so cross about, or—more likely—that bureaucrats are shuffled around the system. The effect of reducing the number of health authorities could be to increase rather than reduce centralisation. Most important, there could be tension between the goal of liberating local talent and the ideal of equity across the NHS, so dear to the public.

The anger of doctors—along with the consequences of Labour's relative parsimony during its first two years in office, and the early deployment of its big ideas—have made health an awkward subject for the government. Ministers have learned the hard way that promising too much—to both voters and employees—can be as perilous as promising too little.

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But does the pope come as healer or neo-crusader?

May 3rd 2001 | DAMASCUS
From The Economist print edition

Pope John Paul's visits to Syria and Greece are stirring controversy

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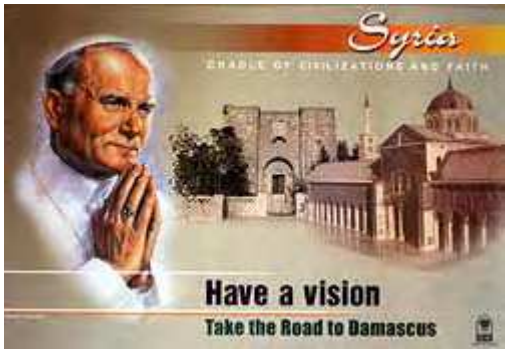

ON A desert crag of Syria's Qallamoun mountains, a troubled goat-milking Jesuit, Paulo the Monk, struggles to reconcile the revelations of Christianity and Islam. At the nearby sixth-century convent of Saidnaya, Sister Christina lists the latest patients she has healed with her Virgin Mary olive oil: a lame Ismaili, a wounded Muslim soldier, even a tired Jewish tourist. Imams recite sayings of the Prophet Muhammad, enjoining men of different religions to pray in each other's houses of worship. But this Sunday will be the first time a Roman Catholic pontiff will have entered the doors of a mosque.

Does Pope John Paul's visit to Damascus's Umayyad mosque bestow papal recognition that the mosque, and hence Islam, is holy? The Vatican says that the pope visits only sacred places. But it is ambivalent on whether the mosque is sacred because it is Muslim, or because it was once a Byzantine cathedral, houses the head of St John the Baptist and is still venerated by Christians. Only last week the Catholic church suspended a Jesuit who had suggested that Jesus might not be the sole path to salvation.

That has not gone down well with the pope's hosts. If he is coming to recognise Islam as a revealed religion, as Islam does Christianity, then *salamu aleikum* (welcome). But there is fear that he could be taking the road to Damascus less on a mission of harmony than of hegemony: to uphold Christ's superior claim. Demands for clarification have been met with silence, and Muslim doubts are fast turning to suspicion.

Such doubts have already forced the 92-year-old grand mufti, who has devoted his long life to inter-religious dialogue, to cancel a prayer session he had hoped to hold with the pope in the mosque. The pope, fumed Syria's Friday preachers, was a "neo-crusader", wielding calls for dialogue where his predecessors had wielded the sword. It did not help that the Vatican had already signalled that the pontiff had no intention of apologising to Muslims directly for the crusades. Muslims should first, said some bishops, say sorry for the prophet's earlier invasion of the Byzantine Levant.

Sensitivity about the Christian West's medieval military adventures in the holy land will also be running high in Greece, where the pope is due to pay a controversial visit before Syria. Whatever their differences, Muslims and Orthodox Christians are at one in shuddering at the memory of the crusaders, whose capture of Constantinople in 1204 is seen as a black day in Greek history.

In Syria, many non-Catholic Christians also feel uneasy about the papal visit. The Roman Catholic church is a relative newcomer to the Middle East. The crusades aside, it entered in 1724 by backing one rival patriarch against another. French colonialists lent their support, closing Orthodox schools and opening Catholic ones. Though Syrian Catholics keep eastern traditions (their priests can even marry), they reap the rewards of Rome's richer endowments.

The Greek Orthodox church remains Syria's largest Christian community, but the Catholics are fast stealing souls and holy places. Above the convent of Saidnaya, once the second pilgrimage site in Christendom, the Catholics have opened a towering, and overshadowing, monastery.To Muslims and eastern Christians alike, papal policy feels like territorial and spiritual expansion. The pope's visit to the Orthodox patriarch of Antioch, Ignatius Hazim, could be as fraught as his entrance to the Umayyad mosque.

All this worried mumbling is unsettling for Syria's leaders. They had looked to the papal pilgrimage to promote the country as the showpiece of interfaith coexistence in the Muslim world. Syrian Christians, who make up perhaps 10% of the country's 17m people, hold Easter drum parades in central Damascus,

and carry giant edifices of the crucified Christ through the streets. Muslims go to churches on feast-days (often to drink the local arak), and Christians join in the annual festivities for the prophet's birthday.

As encouragement, the late Hafez Assad went to both church and mosque. His sect, the Alawites, is the product of interweaving religions, celebrating the eucharist by drinking the body and blood not of Jesus, but of Ali, Muhammad's son-in-law. Syria is short on human rights, but its minorities have religious rights in abundance. Now the fear is that differences over the pope's arrival could awaken sectarian tensions. Assad exterminated the Muslim Brotherhood in the massacre at Hama in 1982. But today, in mosques safe from informers, preachers from Syria's majority Sunni sect denounce the Alawite regime that lords it over the eastern Mediterranean coast after 1,400 years of Sunni rule.

President Bashar Assad has done much to appease Sunni resentment, including marrying a Sunni. He appointed a Sunni preacher to perform his father's funeral rites, and chose a Sunni mosque for his first public outing. Many Alawite women now wear headscarves, the standard Sunni garb, and Sunni intellectuals muse hopefully at the gradual dissolving of Alawite tradition into the Sunni mainstream.

But the changes are cosmetic: the upper echelons of the president's power base remain firmly Alawite, and Sunnis still feel slighted. While the president waits for the pope to bless him as the protector of Christians, Sunnis preach of the dangers of allowing religious minorities unbridled power.

Can John Paul help to ease the sectarian tensions? The pope has devoted an impressive amount of his declining energy to improving relations with other Christians and other monotheistic religions. But his latest journey to the East may show up the limits of that effort. No state visit or set-piece ceremony can change the fact that the Christian view of Christ as God Incarnate is as alien to Muslim sensibility as it is fundamental to Christianity; nor will the pope's olive branches to the Eastern Orthodox bridge the two churches' profound differences.

But on an everyday level, whether on the streets of Damascus or on the few Greek islands where Orthodox and Roman Catholics coexist, people can rub along pretty well and find merit in each other's piety. High religious politics does not always help.

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Israel

Artful dodgers

May 3rd 2001 | JERUSALEM
From The Economist print edition

OUTSIDERS, in Europe and the Arab world, have been making it plain to Shimon Peres, Israel's foreign minister, that, unless he can point to some achievement, he risks being written off as Ariel Sharon's apologist or fig-leaf. Three months after the two septuagenarians came together in government, Israel's "Mr Peace" is being called on to bring Israel's hardline prime minister back to the negotiating table, and so save the region from plunging further into turmoil because of the unrelenting violence between Palestinians and Israelis. This week alone, eight Palestinians, including two small children, are dead. So is one Israeli. And Israeli tanks have again driven into Palestinian-controlled areas of Gaza.

EPA

Is Peres (left) just a gleam in Sharon's eye?

Although Mr Peres has all along insisted that he would in no way describe himself as serving Mr Sharon's interests, he was, according to veteran Peres-watchers, becoming edgy about the relationship. Then, two weeks ago, Mr Sharon stumbled. Under American pressure, he backtracked hastily from a bungled military incursion into a wedge of Palestinian-controlled Gaza—and Mr Peres seized his chance to launch a diplomatic gambit, counteracting a trend that seemed to be setting Israel on the path to unrestrained military escalation.

An Egyptian-Jordanian initiative about how to end the fighting, which had been scornfully dismissed as a hostile Palestinian ploy, was suddenly revived. Mr Peres went off to Cairo and Amman to talk about the plan, and this week is in Washington to discuss it with the Americans.

Hopes that anything will come out of these talks should not be exaggerated. The prime minister has carefully delineated just how far Mr Peres can go in accepting the initiative, or seeking amendments to it. A stop to the shooting, and the length of a trial period before some sort of negotiations restart, can be discussed. But there is to be no acceptance of the plan's call for a Jewish settlements freeze, and no talk about creating a definitive framework for new peace ideas.

Even so, by getting Mr Sharon to rescind his absolute No to the plan, Mr Peres feels he has answered the fig-leaf charge. Moreover, few Israelis imagine that he has not, in fact, talked to his Arab interlocutors about how they envisage pushing forward on peace once a truce has been achieved.

Mr Peres's own description of how he manoeuvred another prime minister, the late Yitzhak Rabin, to stay sweet on peace-making is now very apt, says an Israeli columnist, Nahum Barnea. In order to create the right climate for decisions on an impending agreement, Mr Peres's secret formula was to create deliberate confusion. It invariably worked: with each side unclear on the precise issue, or where they all stood, Mr Peres and his negotiators would intervene with a pre-planned "salvage formula".

Confusion-making may work less well with Mr Sharon. In Washington, Mr Peres has been taking the line that Yasser Arafat should not be held totally accountable for all acts of Palestinian violence. He was immediately contradicted by an unequivocal statement, issued from Mr Sharon's office, which declared that all violent actions by the Palestinians were "the result of a strategic decision by Arafat".

The two veteran artful dodgers of Israeli politics are all too well aware they do not have the same strategic objective. But their tactics seem to suit each other for now. Mr Sharon is, in effect, saying, "Do what you need to keep the world off my back, and to stop Israel sliding into pariah status." Mr Peres, for his part, is playing ball in the hope that by keeping things moving he can eventually shift Mr Sharon. The foreign minister is said to believe that all that separates the Israelis and Palestinians from agreement on

a truce is the wisdom of a good contract lawyer. If he does manage to find a way to end the fighting, Mr Sharon would probably have no alternative but to go along with it.

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Palestinians

Spring-cleaning Arafat's way

May 3rd 2001 | ABU DHABI
From The Economist print edition

ONE of the *intifada*'s minor themes has been a persistent call that the Palestinian Authority should clean up its act. Disgust at corruption has become public. And, in its own way, the authority is responding.

For example, nobody has been arrested for the murder in January of Hisham Mikki, the allegedly corrupt head of the Palestine Broadcasting Corporation, and though the dead man was declared a "martyr", his assets have been frozen. Then, last month, Jaweed al-Ghussein, a former head of the Palestine National Fund, was arrested in his home in Abu Dhabi and whisked away by private plane, first to Egypt and then to Gaza, where he is detained facing trial for allegedly failing to return no less than $6.5m of Palestinian public money.

But Mr al-Ghussein's story has several, possibly personal, dimensions. Aged 70, and now a prominent businessman in the United Arab Emirates, he was once a close friend of Yasser Arafat's. The tale of the missing money is convoluted, and Mr al-Ghussein's family hold to a version that shows him honourable. Be that as it may, the scandal was exhaustively investigated by the UAE courts over two years, at the end of which he was cleared on appeal by the Supreme Court. The Palestinians say he was "extradited" by the UAE to Gaza. But he had lived in Abu Dhabi for 35 years, had a Jordanian passport, and his removal took place in apparent contravention of international law.

If the Palestinians start investigating the theft of public money, everyone should be relieved. But the pursuit of financial scandal could begin considerably closer to home—and be conducted in a much more orderly way than snatch and murder.

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Happy hookahs

May 3rd 2001 | CAIRO
From The Economist print edition

IN THE cafés of Cairo these days, there is much head-wagging about the perils of globalisation. Puffing on their hookahs, patrons mutter about the unstoppable invasion of American fast food and trash television. Few realise that the hookah itself is stealthily kippering the globe.

They should ask Murad Askar. Two years ago he lugged his suitcase full of waterpipes from Egypt to California, thinking his fellow college students might like to try a water-cooled smoke. “They went nuts,” he says simply. Mr Askar’s company, Hookah Brothers, is now shifting 4,000-5,000 units a month to clients in 47 American states. Aside from the standard smoking gear—hollow glass bases, stainless-steel “hearts”, hoses and clay pipes—the company sells over a tonne of sticky hookah tobacco a month, in 20 flavours ranging from strawberry to mango.

It has recently branched into franchising. “We’ve got 50 full-service accounts so far,” says Mr Askar. “We set up a whole hookah system, including equipment, staff training and management advice.” Smokers in Cairo, who pay about 25 cents for a charcoal-lit bowl of tobacco, may marvel to know that one high-class joint in Boston charges $20 for the same treat.

An Egyptian wholesaler reckons his country is exporting some 200,000 of the gadgets a year, a four-fold increase in the decade since the only export market was among fellow-Arabs in the region. He now has customers as far afield as Korea and South Africa. Even at home the fashion has taken off. Not so long ago, waterpipes were the preserve of idle working-class men. Now Cairo’s top hotels bubble to the sound of percolating smoke. And nobody blinks at the sight of a veiled lady getting a soothing public nicotine fix.

Cairo’s hookah *aficionados* admit that the instrument was invented in Ottoman Turkey, but claim it was perfected in Egypt. But Egyptian ingenuity is now being challenged. American taste runs to multiple hoses for communal smoking of a single pipe, and safer, screw-on metal caps to cover the live coals. Mr Askar now imports parts from Mexico and China. Jordan produces the best smoking charcoal. Top-notch tobacco comes from Bahrain, and from a firm in Saudi Arabia that is experimenting with what may be the hit new flavour: Coca-Cola.

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Congo

Kabila, a victor in peace

May 3rd 2001
From The Economist print edition

The son, more statesmanlike than his father, has been helped by a UN report

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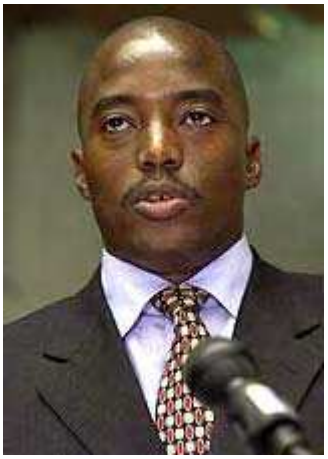

A smoother son

THE war staggered to a stalemate in 1999 but Joseph Kabila, who became Congo's president after his father was assassinated last January, seems to be winning the peace. Whereas Laurent Kabila was put in power only to use it for himself, his son Joseph has been more flexible, thus winning the authority and status his father lacked.

Two years ago the Congolese government had its back to the wall. Rebels, backed by Rwandan and Ugandan troops, were poised to attack areas of economic importance; its own Angolan and Zimbabwean allies were pressing for a settlement. A reluctant Kabila was made to sign a ceasefire agreement in Lusaka, Zambia's capital, with the governments fighting in his country.

The Lusaka accord was designed to re-establish the unity of Congo's vast and largely ungoverned land. It called for the withdrawal of all the intervening armies, the deployment of United Nations troops and a conference of Congolese parties, armed and unarmed. Such was Kabila's weakness that he had to accept wording that treated all foreign armies without distinction, even though he had "invited" some, whereas others had "invaded". He also agreed to take part in a "national dialogue" on an equal basis with the three rebel movements and other Congolese political leaders.

Seeing that the Lusaka agreement would spell his political oblivion, Kabila blocked it at every turn. His son has been cleverer and more statesmanlike. He has allowed the UN to deploy its monitors and their guards, and has won western friends by agreeing to economic reform and the appointment of a cleaner-looking government. Meanwhile, the Ugandans and Rwandans have been losing friends. They have fought each other, they control unpopular rebel movements—and they have been looting eastern Congo of its minerals and other natural resources.

A UN committee set up last year to investigate this looting has denounced both Uganda and Rwanda for the illegal exploitation of Congo's resources. Its report, released in mid-April, is extraordinarily detailed, naming Major-General Salim Saleh, the brother of Uganda's president, Yoweri Museveni, among the senior Ugandan and Rwandan commanders whom it accuses of stealing diamonds, gold, coltan (a mineral), timber and ivory. It calls for sanctions against both countries. Although the report also mentions exploitation by Zimbabwe and Angola, it gives few details. Indeed, it treats such goings-on as legitimate because the deals are said to have been made by agreement with the Congolese government.

Both Uganda and Rwanda have attacked the report as malicious, shoddy and unfair. Some see it as a French plot—indeed, the French who felt that Africa's largest francophone country was stolen by anglophones when Laurent Kabila, then backed by Rwanda and Uganda, took over in 1997, are said to be delighted by recent events.

President Museveni, deeply angered by the UN's suggestion that Uganda's main reason for being in Congo was for looting rather than for security, has said he will withdraw from the Lusaka peace process. He will also hasten the promised withdrawal of troops. Ugandan officials say the president is serious about the troops; senior military men say the decision has already been made and a full pull-out will take place in mid-May. Mr Museveni's threat to withdraw from the Lusaka process, however, could be brinkmanship: he may be hoping that the UN will plead with him to stay involved.

The report has damaged the rebels' cause by its acceptance of Mr Kabila's regime as Congo's legitimate

government. The presence of Angolan, Zimbabwean and Namibian troops is seen as legitimate, since they were requested to intervene by the government. By the same argument, the presence of Ugandan and Rwandan troops is presented as illegal aggression. Significantly, Britain and America have done little to protect their friends, Uganda and Rwanda.

There are fears that Mr Kabila will exploit this new legitimacy by diverting the forthcoming “national dialogue” into little more than a talking-shop. He clearly has no intention of being just another participant, as the Lusaka agreement prescribes, and will expect to be recognised as head of state. However much this infuriates Congo’s other politicians, the unarmed ones are powerless and the rebels will be weakened if their foreign backers now withdraw.

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Zambia

Third-term men

May 3rd 2001 | LUSAKA
From The Economist print edition

SIX cabinet ministers were beaten up for defying Zambia's president, Frederick Chiluba. One suffered a broken arm. Another said she was threatened with rape. The police told the rebellious vice-president, Christon Tembo, that they could not protect him if he attended his own party's conference. Zambian politics is starting to sound a little, well, Zimbabwean.

Mr Chiluba seems to have learned a trick or two from his neighbour, Robert Mugabe. Like the Zimbabwean despot, he is keen to stay in power indefinitely. Mr Mugabe stifled calls for his resignation at a party conference in December by packing the hall with aggressive flunkies, and barring suspected dissidents from voting. Mr Chiluba did much the same at a conference of his party, the Movement for Multiparty Democracy (MMD), on April 28th and 29th.

At issue was whether Mr Chiluba should run for an unconstitutional third term. Since the MMD was founded to oppose the idea of presidents-for-life, this required changing the party constitution. Mr Chiluba managed to swing the vote his way by various means. Suspected opponents found it hard to get on to the list of delegates for the conference. They also found it hard to get into the hall, because thugs clobbered them while the police watched apathetically. Inside the hall, heavies chanted "third term, third term". No speaker dared dissent.

All this makes many Zambians nervous. Local history gives them cause. Since independence, seven out of eight neighbouring countries have at some stage endured presidents with a distaste for term limits. During Zambia's own experience of one-party rule, the economy was paralysed by controls. When Mr Chiluba was first elected in 1991, he promised democracy and prosperity. Ten years on, Zambians are even poorer, although the privatisation of the country's copper industry last year may improve matters. And Mr Chiluba's commitment to democracy is now in doubt.

To stay in power beyond October, when his term ends, he must change the national constitution, too. This needs a two-thirds majority in parliament and roughly 80 of the 158 MPs have said they will oppose it. But the opponents include about 60 MMD members, who could be expelled from the party, and so from parliament. On May 1st the rebels won a court ruling preventing the president from expelling them. Ignoring this, the MMD then expelled Mr Tembo and some 20 others.

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Algeria

The Berbers rise

May 3rd 2001
From The Economist print edition

SOME are already describing the week-long riots in Algeria's Berber-speaking region as an *intifada*. More than 60 people in Kabylia are dead. They were not, however, killed by an occupying army, but by their own country's armed forces, instructed to quell a huge eruption of anger.

EPA

Fleeing despair and the gendarmerie

The riots were set off by the death of a young Berber taken in for questioning by the gendarmerie, the force responsible for order in the countryside. In a belated explanation, the authorities said that his death had been an accident, and the guilty gendarme would be punished. But this failed to still the protests that swept through the five provinces of the Kabyle heartland in north-east Algeria.

The streets of the two regional capitals, Tizi Ouzou and Bejaia, turned into battle zones as young men clashed with the riot police. In towns and villages throughout the region, protesters attacked and destroyed government buildings and tried to overrun police stations. They were, and are, demanding the withdrawal of the gendarmerie from the region. But they have also been making it clear that they have had enough of what they call *hogra*, their neglect by their rulers. This is a frustration that affects most young Algerians. They want employment, housing and a future.

Algeria's civil war, which broke out after the army cancelled an election in 1992 to prevent an Islamist party from winning it, brought new pressures and new insecurity. But Kabylia had been chafing at the authority of the central government ever since the early years of Algeria's independence in the 1960s. It is the country's most politicised region, always pressing to have the Berber language and culture recognised: some 20% of Algerians are Berber-speakers.

One of the two Berber-based political parties announced that it was pulling out of the government in protest; the other called for a peaceful anti-regime demonstration in Algiers. Yet both parties have come to be viewed as ineffective, and their local offices were attacked by the rioters. "There is no one with the necessary credibility to talk to the young rebels," said Abdessalam Ali Rachedi, an opposition MP. "The divorce between the regime and society is total."

A week after the start of the riots, in a bid to restore that lost credibility, President Abdelaziz Bouteflika promised an honest inquiry into the violence. He said he understood the demonstrators' suffering, and their despair. He claimed that (unnamed) forces both inside Algeria and abroad had been "fanning hatred, and sowing subversion and division" and suggested that the issue of the Berber language might be dealt with in an amendment to the constitution.

But Algerians remain sceptical of Mr Bouteflika's ability to change things. He is locked in an unending power struggle with the all-powerful generals to whom he owes his position. They picked him as president because they hoped that this would make the regime, which faces much criticism abroad for its human-rights record, look a bit better. Mr Bouteflika has sought, not very effectively, to assert his own authority at the generals' expense. It may not be a combination capable of putting Algeria right.

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The rise and the fall

May 3rd 2001
From The Economist print edition

The fall in global equity markets has delivered a salutary shock to investors. But it should not stop the spread of an equity culture around the world, says John Peet

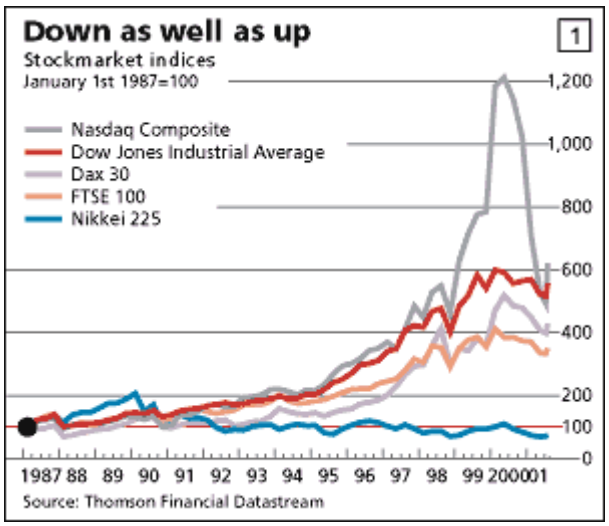
THE first few months of 2001 have been tragic in a classical sense: the hubris engendered by the long rise in most of the rich world's equity markets has duly been followed by the nemesis of their sharp fall. Now the world is gloomily contemplating the possibility of the first sustained, globally shared, bear market for a quarter of a century. All those who have spent the past five years predicting a crash, even as the markets attained ever giddier heights—including, it should be confessed at once, this newspaper—are feeling belatedly vindicated.

There have been other sharp falls in equity prices, and indeed several genuine bear markets, within living memory: in the 1970s, for example, or, even more painfully, over the past decade in Japan. But most of today's investors have never experienced them. Some may even have begun to assume that, perhaps thanks to the benign influence of America's Federal Reserve, it was normal for share prices to keep going up and up. Yet, historically, what is truly unprecedented is not the arrival of a bear market. It is the extraordinary two decades of rising share prices that ran until late last year.

It is worth putting the figures on record before the bears stamp out the memory altogether. At the start of 1982 the Dow Jones Industrial Average stood at 875; the index for the exuberant and then newish Nasdaq stockmarket was 196. Eighteen years later, at the start of 2000, after the longest and strongest bull market in history, the two indices stood at 11,497 and 4,069, respectively. That meant they had run up average annual real increases over that period of 11.7% and 14.6%, respectively. And this included, among several other dips, the great crash of October 19th 1987, when the Dow fell by 23% in a single day.

Over the past year, the markets have fallen back sharply, with the fall picking up speed as company profit warnings and worries about a recession have spread. Until a recent recovery, the broad S&P 500 index had fallen by well over 20% from its January 2000 peak (a 20% fall is widely, if unofficially, regarded as defining a bear market). The Dow has fallen by less, but it too is well off its peak. As for the technology-heavy Nasdaq stockmarket, despite its recent climb, it is down some 60% from its peak in March 2000. Plenty of blood-curdling figures have been hurled around. Some $3 trillion has been wiped off the nominal value of America's stockmarkets, equivalent to (though not comparable to: one is a stock, the other a flow) a third of the country's GDP. Around the world the paper loss amounts to as much as $7 trillion.

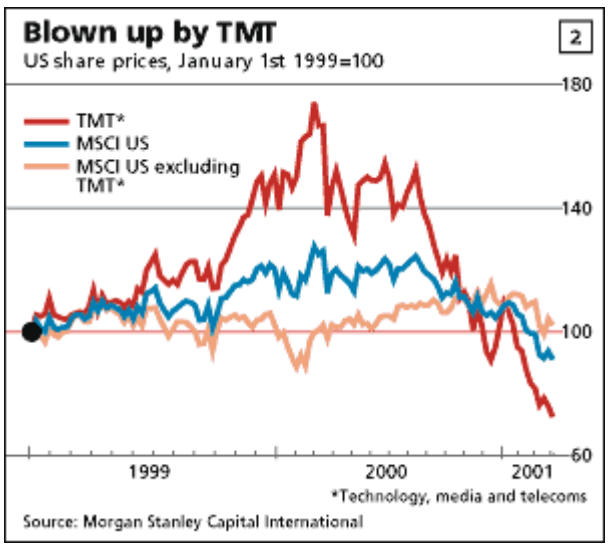
As chart 1 shows, Europe's stockmarkets have mostly followed a similar path to America's, with a slightly less dramatic rise followed by an equally sharp decline. Europe's smaller technology markets have seen an even bigger short-term boom and bust than the Nasdaq. Among rich countries' markets, only Japan's has followed an essentially different path, reaching a peak at the end of 1989 from which it crashed, and has since stagnated as worries about the economic outlook have increased. All in all, it seems safe to conclude that, whether or not the bear market persists, the long bull market is well and truly over.



Bulls and bears

What caused markets to put in such an unprecedentedly strong performance in the first place? Many things, not least two broadly successful decades of macroeconomic performance, with mostly low inflation and steady growth (except in Japan). Yet equity valuations, as we shall see, are a matter of huge controversy, and markets have a pronounced tendency to get out of line with economic fundamentals, producing froth or even bubbles. The sharpness of the fall into a bear market, at a time when the real economy has done little more than slow down, suggests that this may have been happening in the 1990s.

It is the now notorious technology, media and telecoms (TMT), or “new economy”, bubble that was largely responsible for the heady rise in the markets, and it is its deflation that was responsible for a big part of the subsequent fall. If TMT stocks are taken out of the equation, the rest of the market (sometimes called the “old economy”) was much less buoyant in early 2000; until this spring, it seemed to be partly recovering, confirming its inverse relationship with TMT (see chart 2). Yet bear markets can always be defined away by excluding those sectors that have fallen farthest: that does not make them any less real. Besides, shares have recently declined right across the board.



Alongside the cyclical market rise, and now fall, there has been a structural factor at work in the 1980s and 90s. This factor, which might be called the equitisation of world finance, forms the main theme of this survey, which will seek to answer one of the big questions of the moment: can the new “equity culture” around the world survive a bear market?

Equitisation is only part of a veritable revolution in finance that has taken place over the past 20 years. In most countries, including America, capital markets at the start of the 1980s played a much smaller role than they do today. Banks, once the staid but trusty handmaidens of industry, have been subject as never before to competition and to an erosion of their traditional functions. New financial instruments,

from derivatives to high-yield (“junk”) bonds, and from swaps to sophisticated options, have been invented and popularised. Securitisation has turned almost any income-producing asset into a tradable instrument. And technology has changed finance perhaps more than any other industry outside computing itself.

Under the buttonwood tree

It may seem surprising, against such a background of febrile change, that something as old-fashioned as equity should have come so strongly to the fore. Stock exchanges have, after all, been around for centuries. The New York Stock Exchange (NYSE) dates back to 1792, when traders met under a fabled buttonwood tree close to where the Big Board’s floor still stands. The London Stock Exchange began trading in its present form in 1801. Amsterdam’s bourse is older than either. Yet for most of their history, stock exchanges traded government bonds far more than equities. Until relatively recently interest in shares was limited, confined largely to wealthy individuals and a few institutions. But over the past two decades four related trends have changed that.

The first is rising issuance of equity on the public markets, not least shares in companies that had been either state-owned or privately held. Dick Grasso, the combative chairman of the NYSE, likes to cite his two conservative heroes of the 1980s, Margaret Thatcher and Ronald Reagan, as chief inspirations for both privatisation and the spread of share ownership. Mr Grasso now declares that “equity is the crude oil of the global economy”. Ironically, the net supply of new equity in America has actually shrunk recently, thanks mainly to share buybacks by companies.

Elsewhere equity supply has steadily increased. Privatisation, a term coined only in the early 1980s, has given a huge boost to stockmarkets and equity ownership in Europe. The fashion for private or mutually owned firms to list on public stockmarkets, not least to raise capital more cheaply, has spread. The bear market will slow things down: global equity issuance in the first quarter of 2001 fell by 63% compared with a year earlier, to $48 billion. But it seems sure to pick up again.

Second, there has been a growing appreciation of the huge demographic challenge that faces most countries’ pension systems. The old ways of relying on state pensions and pay-as-you-go financing both look increasingly unsatisfactory. Whatever soothing noises governments may make, few prospective beneficiaries now believe that they can depend on these systems in their old age. Instead, the trend is towards greater emphasis on privately funded pensions.

Within the private pension business itself, another significant change has been taking place: a steady shift from “defined benefit” to “defined contribution” schemes. In the first (also known as “final salary”), the employer guarantees the level of the pension and assumes the risk; in the second (often called “money purchase”) the risk is shifted to the employee. Individual pension-fund investors, for instance those with 401(k) plans in America, are likely to be especially interested in equity investment. If demographic change is the biggest problem in the provision of pensions, equity has to be the biggest part of the solution.

Third, almost all investors, almost everywhere, have come to understand that, in the long run, only shares hold out the promise of sufficiently large returns to pay for people’s pensions. Over the past two decades the notion that there are better returns to be had from equities, with less risk, than from almost any other financial asset has become entrenched in investors’ minds—perhaps too much so, as they became used in that period to above-average annual returns in double figures. The result has been a proliferation of equity investing, and especially of equity mutual funds, first in America and Britain, but more recently even in such previously unpromising countries as Germany and France.

Today’s bear market, if it endures, will certainly test the enthusiasm for this new-found equity culture. Indeed, one apparently perverse reason for welcoming the arrival of a bear market is that it will remind investors of the main reason why equities have offered better returns: because they are riskier. As the hackneyed phrase from the brochures, usually in small print, has it: “Shares can go down as well as up.” If shares only ever went up, the long-run returns from investing in them would inevitably fall to match their lower risk.

It is because of the riskiness of equities that, over time, they outperform other investments, as repeated studies over many decades, including periods of previous bear markets, have confirmed. Table 3, drawn from a long-running annual equity-gilt study

undertaken by Barclays Capital, shows comparisons for America of equity, bond and cash returns for as much of the past century as there are reliable records. Equities can underperform significantly in any one year—2000, for example, was one of the worst in living memory, and 2001 could well prove worse still. But over most longer periods (barring such an exceptionally gloomy decade as the 1930s) returns have been substantially higher for equities than for either bonds or cash. Jeremy Siegel, a professor at Wharton Business School and author of "Stocks for the Long Run", showed similar results going as far back as 1802 when he compared the returns on shares, long-term bonds, short-term bills, gold and cash.

Shares on top 3

US real investment returns
annual average, %

	Equities	Bonds	Cash
1931-40	3.6	6.4	1.6
1941-50	7.5	-3.1	-5.1
1951-60	13.8	-0.4	-0.2
1961-70	5.3	-1.5	1.3
1971-80	1.4	-3.6	-1.1
1981-90	7.9	8.8	3.9
1991-2000	14.1	7.1	1.9

Source: Barclays Capital

These three structural trends pushing the process of equitisation have, however, become conflated and confused with the fourth (and perhaps biggest) factor of all, which is the two-decade-long bull market itself. In retrospect even the crash of 1987 now looks like a mere blip. It is thanks largely to the bull market that stockmarket capitalisation as a share of GDP had everywhere risen to record levels by the end of 2000. Against the background of such big share gains over such a long period, it is hardly surprising that so many new investors have been lured into the stockmarkets.

In America, for instance, nearly half of all households now own shares, either directly or through mutual funds, 401(k) plans or directly managed pension plans. In Australia, the level of share ownership is even higher. In Britain, the proportion is a little over one-quarter. Germany and France still lag, with less than a fifth of the population owning shares—but, thanks not least to privatisations, they have made tremendous strides from a far lower base. The number of shareholders in Germany now exceeds that of trade union members. Even in Japan, despite its long bear market, the stock exchange claims that around 30m individuals now own shares directly or indirectly.

The impact of equitisation stretches wider than the number of people investing in the stockmarkets. It reflects the broader triumph of capitalism in the post-cold-war era. There are few better symbols of capitalism's success than the spread of share ownership. It is also part of a shift in favour of what is often tagged as the Anglo-American model of capitalism, in which markets, not banks (and still less governments), become the key allocators of capital.

The rise of equities is also affecting the management of companies. Now that larger numbers of investors pay closer attention to the daily movement of their companies' share prices, bosses' main concern has become the promotion of "shareholder value"—all the more so when their own rewards are linked, as they increasingly are, to share performance. In many companies, employees have got in on the act as well. Stock options for staff and employee share-ownership plans have proliferated everywhere, becoming particularly important in America's technology industry.

In Europe, this has pushed company managers into paying far more attention to short-term profit and share-price performance. In America, it has also led to the fad for share buybacks by firms, which have become so popular as to shrink the net supply of publicly traded equity. Everywhere, people now pay far more attention to what is happening in the stockmarkets. One sign is the mushrooming of personal-finance journalism in many countries.

There are broader economic effects too. The spread of share ownership means that a growing proportion of people's savings is tied to the equity markets. This creates a potentially far bigger direct "wealth effect", with consumers adjusting their spending with an eye on the rise and fall of the stockmarkets, regardless of whether they realise their own capital gains or losses. Even more important, stockmarkets are having a growing effect on consumer confidence, and therefore on the economy itself. One of the reasons that consumer confidence fell off a cliff in America at the end of 2000 was the poor performance of the equity markets. Now a vicious cycle may be at work: falls in equity markets contribute to a slowing of the economy, which leads to further falls in the markets.

Equitisation has microeconomic effects as well. Avinash Persaud, an economist at State Street Bank, talks about the equitisation of innovation in the 1990s, by which he means that venture (or private equity) capital was freely provided to innovators, especially in the technology business, in the knowledge that there was an early and profitable exit route through an initial public offering (IPO). Mr Persaud has also shown, on the basis of information in State Street's custodial database, that equity flows across borders account for a growing share of all capital flows, so they are helping to determine the course of exchange rates and the balance of trade.

The effects of equitisation on the world's economies are thus huge. But the biggest question now is how a bear market will influence things. Might it encourage investors to cast around for safer havens, putting an end to the incipient equity culture? And that invites another question: what determines the value of an equity—and a stockmarket?

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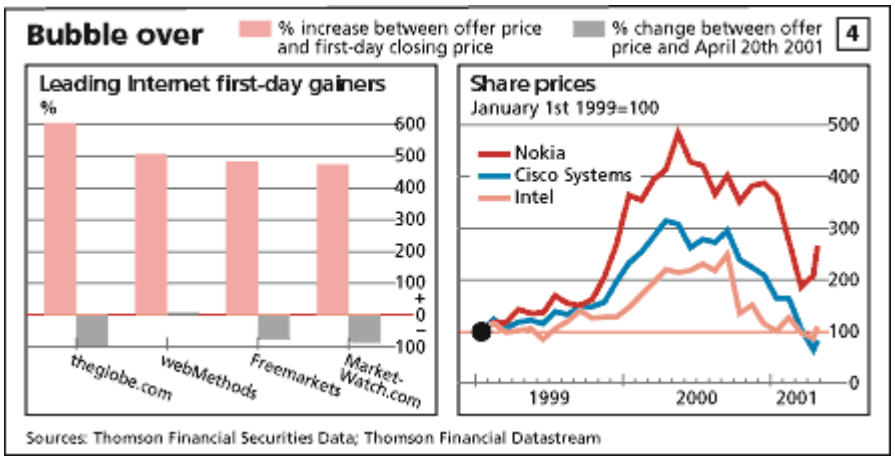
Valuation waltz

May 3rd 2001
From The Economist print edition

There are many ways to value shares, but most of them suggest that Wall Street is still expensive

WHAT is a share worth? On one level, the answer is simple enough: whatever you can sell it for. Indeed, stockmarkets exist for the express purpose of price discovery, as the process is known. But to be told that a share is worth whatever price the market sets for it is not all that helpful. What investors really want to know is how and why the market arrives at that price, to provide them with clues about whether the share is likely to go up or down in future. In other words, what is the fundamental value of a share?

Given the volatility of some equities over the past two years, this is a particularly pertinent time to be asking this question. The example of dotcom shares is only the most notorious. In March 1999, for instance, Amazon was trading at $60; in December that year, it peaked at $106; today its shares are down to $16. No wonder so many Internet-related IPOs proved so tricky to value in 1999-2000. And dramatic volatility has not been confined to the froth of the Internet: look at the movement in the past two years of such TMT blue chips as Cisco, Intel and Nokia (see chart 4).



If shares have a fundamental value, how is it possible to make sense of such swings? There is a classic formula that explains the underlying value of a share, and by extension of a market as a whole. It is known as the dividend-discount model, and it is a staple of the capital-asset pricing model, which in turn is a basis of corporate-finance theory. A share is worth the sum of all its prospective dividend payments, discounted back to their net present value. (Note that the relevant income stream is prospective dividends, not profits, even for companies that pay little or nothing in the way of dividends. Future profits have a value to investors only if they will be paid out one day.)

The trouble with the dividend-discount model is not that it is wrong; indeed, most economists agree that the theory is fine. The problem lies in the uncertainty surrounding both its components: the future stream of dividends and the appropriate discount rate. Yet the model remains essential. If shares change in value, that must reflect a change in investors' assessment of either the prospective dividend flow (for example, because of fears about the future level of profits) or the right discount rate (for example, because of a change in inflationary prospects or in long-term real interest rates), or both.

Another theory that is often linked to the dividend-discount model is that of “efficient markets”, which argues that all existing information is automatically incorporated in a share price. Shares thus follow a “random walk”, a phrase coined by Burton Malkiel, a professor at Princeton University who popularised the theory under this label. The random walk means that nobody should ever be able consistently to beat the market. As Professor Malkiel colourfully put it, you might as well be a monkey throwing darts at the *Wall Street Journal*.

Stockmarket analysts employ several other valuation tools, especially to compare the present and past values of equities and markets. The best-known is the price/earnings ratio or multiple, which divides share prices by profits, or its inverse, the earnings yield. Either can be calculated on a historical or a prospective basis. A second measure is the dividend yield on its own. Then there is the price-to-book ratio, which measures a company’s stockmarket value against the book value of its assets. And there is Tobin’s q, a ratio of the stockmarket value to the replacement cost of its tangible assets—an attempt to measure what it would cost to recreate a company from scratch.

Other measures are employed to compare equity values with those of other financial assets. The dividend or earnings yield, for example, can be compared with bond yields. At one time analysts liked to do this by quoting the yield gap (though this became inverted when dividend yields fell below bond yields in the 1950s) or the yield ratio, both of which relate share to bond yields. Today they talk of the “Fed model”, which divides earnings yields by Treasury-bond yields. Whenever the result falls below one, equities are (comparatively) cheap.

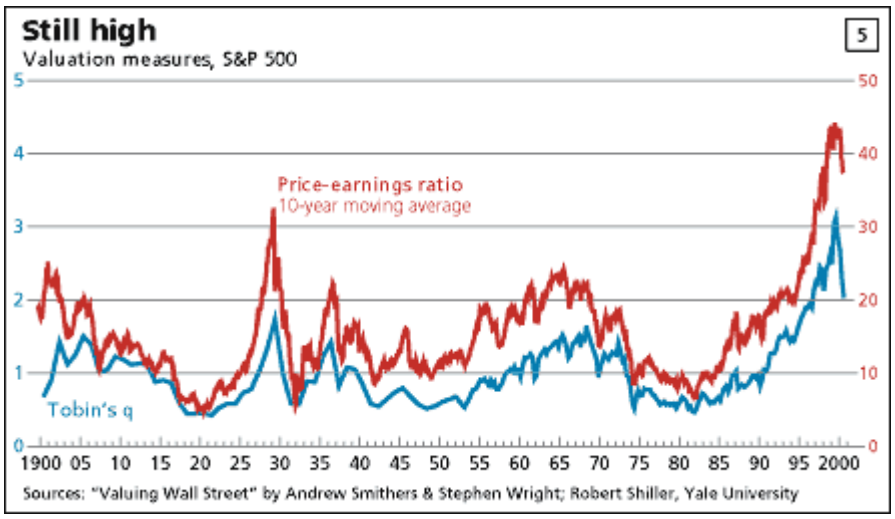
Yet another much-cited variable is the “equity risk premium”, which measures the extra return that (risky) shares must in theory offer over the (risk-free) return that is available on government bonds. The premium is generally calculated for a market as a whole. But there are also measures of volatility applied to individual shares. The best-known is “beta”, which measures a share’s volatility relative to that of the market as a whole. Small-company shares, in particular, usually have a higher beta, because they are riskier and less liquid. That should translate into higher returns.

None of these indicators is, however, wholly satisfactory. Profits (or earnings), for instance, are largely an accounting concept that can easily be massaged by clever finance directors. Yield ratios may not be reliable at times of lower inflation, or when the supply of government bonds shrinks. Bonds are not, in any case, riskless, as anybody who has held them at a time when inflation was rising can testify. As for Tobin’s q, it omits intangible capital, which has grown in significance as both brands and intellectual property have increased in value.

The equity risk premium can be calculated only after the event. Moreover, for many years it was seen by economists as presenting a puzzle, in that it seemed higher (it was roughly 6% for the American stockmarkets over the past century) than the apparently reliable long-run return from equities justified. Lots of theories have been produced to explain this puzzle, but the most plausible answer may be that the premium varies according to the circumstances and the markets’ liquidity—which is pretty useless if you are trying to make predictions. Even beta seems to have lost some of its forecasting ability: small-company shares have not produced higher returns than big-company ones over the long bull market of the 1980s and 1990s.

Yet even if these valuation measures are unsatisfactory and sometimes contradictory, they do have at least one thing in common. Virtually all of them suggest that the two-decade bull run pushed America’s stockmarkets to extraordinarily high levels by historical standards. Worse, most of the measures also suggest that, even after the sharp falls in recent months, the markets remain highly valued.

Chart 5 is based on a similar chart in “Irrational Exuberance”, by Robert Shiller, a professor at Yale. The book drew its title from a famous remark about the market’s heady level by Alan Greenspan, the chairman of the Federal Reserve, in December 1996 (when the Dow stood at a mere 6,500, 40% less than today). The chart shows that the p/e ratio for the broad S&P 500 remains near record levels. It also shows a similar story for Tobin’s q, the preferred measure of Andrew Smithers, who runs an eponymous London research firm. No wonder the markets have fallen in recent months.



The bold souls who last year were publishing books with such titles as “Dow 36,000”, “Dow 40,000” or even “Dow 100,000” have tended to assert that the equity risk premium has fallen sharply, perhaps even to zero, as investors have woken up to the long-term stability of equity returns, and also to the promise of the “new economy”. As noted above, the premium has been surprisingly high in the past. But shareholders, who have no claim on a company in the event of bankruptcy, are clearly taking a bigger risk than bondholders, who not only have a reliable stream of interest but also a legal creditor claim. And if there were ever any doubt, the recent fall in the markets surely disproves the notion that the risk premium might have sunk to zero.

Squeezing the risk premium

There is, admittedly, some evidence to suggest that the risk premium might have fallen a little. Economists at the OECD reckon that it has tended to decline as inflation has come down, perhaps because this has made equity returns seem more stable. A long bull market itself also tends to push down the risk premium—as it did, although only temporarily, in the 1920s. The rise of the equity culture and the spread of the understanding that, in the long run, shares tend to outperform most other assets may also have helped to lower the risk premium. But none of these factors could possibly push the premium close to zero, so today’s valuations still look unjustified.

In any case, today’s bulls no longer talk so much about a disappearing risk premium. They mostly admit (at least in retrospect) that the Nasdaq, in particular, and the broader TMT sector in general, until the spring of 2000 experienced a classic speculative bubble that has now been largely deflated. The rest of the market, they say, has fallen less dramatically mainly because it never rose to such overvalued levels in the first place.

Thus most well-known equity analysts, among them Goldman Sachs’s Abby Joseph Cohen, have returned to their traditional view that now is the time to buy shares (not that many ever advocated selling, even at the peaks of early 2000). Several academics share this view. Wharton’s Jeremy Siegel, for one, reckons that, at least outside the TMT sector, today’s market is reasonably fairly valued. He still believes that investors have nowhere better to go in the long term. As for the markets’ huge climb since 1982, Mr Siegel puts it down not to a vanishing risk premium but, more simply (and more plausibly), to the fact that shares were more undervalued in 1982 than at any previous time this century.

The bears are not convinced. Jim Grant, a shrewd independent economic analyst, and Barton Biggs, of Morgan Stanley, both reckon that the deflation of the Wall Street bubble has a long way to go yet. Professor Shiller observes that the Nasdaq, which even now is trading on a prospective p/e ratio close to 100, remains hugely overvalued by all historical standards. Even the broader market, with a prospective p/e ratio of 25 or so, still looks expensive—and it does not yet take account of the impact of America’s slowdown on future profits, which could cut the denominator of the ratio even as the numerator falls. He dismisses the notion that the risk premium has fallen sharply. And he sees no reason to change traditional valuation measures.

London-based Mr Smithers is more bearish still. He disagrees with Mr Siegel’s argument that shares are always the best investment for the long term, noting that it is crucial to be out of the market when bubbles burst. It took 25 years for the Dow to regain its 1929 peak. Last March, Japan’s Nikkei briefly fell

to its lowest level for 16 years. Mr Smithers also rejects the argument that long-term investors have nowhere else to go. Such “wall of money” arguments, he notes, were also put forward in the 1920s, and in Japan in the late 1980s.

Optimists and pessimists may not agree about whether today’s bear market will last. But they almost all agree that the Nasdaq, at least, experienced a speculative bubble in the late 1990s comparable to that seen in Japan a decade earlier. Even Frank Zarb, the Nasdaq’s chairman, talks now of “an exuberance that was somewhat irrational.” Why, though, do bubbles occur? You might have thought that efficient markets, armed with both the experience of history and the valuation tools discussed earlier in this chapter, would prick them before they are formed. There are several answers, besides the obvious one that markets may not in fact be as efficient as the theory supposes.

The madness of crowds

For one thing, markets reflect crowd behaviour; for many investors, the best guide to what may happen next is what has just happened, a belief in “momentum investing” that seems bound to turn most bull markets into bubbles. From tulips to railways to electricity to the Internet, crowd behaviour has created financial bubbles on the “bigger fool” theory: that a share is worth buying, even if it looks expensive, so long as there is reason to hope that somebody else will pay even more for it in future. Markets do not, in any case, seem to learn from history; at best, a generation that has been burnt does learn its lesson, but the next generation promptly forgets it.

Mr Shiller laments that not enough research has been done into behavioural economics, which he suspects is a far bigger influence on markets than any number of sophisticated valuation measures. John Maynard Keynes, no mean speculator himself, understood this, famously fretting about the consequences if a stockmarket became a kind of casino. He wrote of the market valuing shares “under the influence of mass psychology. It is, so to speak, a game of Snap, of Old Maid, of Musical Chairs—a pastime in which he is victor who says snap neither too soon nor too late, who passes the Old Maid to his neighbour before the game is over, who secures a chair for himself when the music stops.”

As for a “new economy” justifying sharply higher stockmarket values than in the past, Mr Shiller notes that similar arguments were made in the 1920s. As he puts it, “we are in a new economy, and always have been for 150-200 years.” The experience of the Internet bubble bears out his thesis. Faced with rising share prices that bore no relation to traditional valuation criteria, many analysts invented new criteria (eg, revenues instead of profits) rather than conclude that the shares were wildly overvalued, and that much of the hype about the new economy was a fiction.

Mr Smithers offers another analysis, based on the incentives held out to company bosses. He notes that the biggest (and in some years, in net terms, only) buyer of American equities in the late 1990s was the corporate sector, especially through share buybacks, which became popular as a more tax-efficient way than dividends of distributing profits to shareholders. The trouble with share buybacks is their linkage to stock options, which have become an increasingly popular way of remunerating managers. By buying back shares, a boss can, in effect, inflate his own pay—and, because stock options (absurdly) do not appear in a company’s income statement, he can even do it without affecting recorded profits. This cocktail of incentives, buybacks and overstated profits was an ideal recipe for creating a bubble, argues Mr Smithers.

Although the bears may be overstating their case, there are strong arguments for believing that America’s markets are still overvalued—even before factoring in a possible sharp slowdown in profits growth. Should an American recession really take hold, the markets could have a lot further to fall. Only if economic growth, and so profits, prove surprisingly robust is a sustained bounceback likely.

The resulting uncertainty is likely to slow down the spread of the global equity culture, especially in countries in which it is relatively new. There is also considerable nervousness among those who make a living from equity dealing. Investment banks have recently been taking turns to announce poor results, profit warnings and even lay-offs. And stock exchanges, which have also benefited from the long bull market, would have much to lose from further falls in the markets too—particularly at a time when they are facing plenty of new competitors.

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Exchange places

May 3rd 2001
From The Economist print edition

America's leading stock exchanges need modernisation

IF YOU are looking for a totem of the long bull market, and indeed of the world's new equity culture, you will find one on your television screen, which daily relays the drama of the opening bell being rung on the New York Stock Exchange. On the packed floor below, traders mill about, brokers shout and paper is thrown in all directions, most of it ending up on the ground. It makes a splendid picture. Yet it also prompts a question. Is this not the new age of disembodied, computerised trading? If so, why is there still a trading floor at all?

That question is one of many that make some observers despair of the Big Board's future. But before joining the NYSE's critics, it is worth pausing to ponder the exchange's spectacular success—testimony to the strength of America's equity culture. Fifteen years ago, the NYSE traded 107m shares a day; now it trades 1.2 billion. In the mid-1980s, fewer than 100 foreign companies were listed; now over 400 are, albeit mostly in the form of American Depositary Receipts (ADRs), with the underlying shares held overseas. Most of the archaic rules that protected the exchange from competition have gone. Fixed commissions went in 1975, and more recently rule 390 (which sought to ban trading in a NYSE-listed stock on other exchanges) and rule 500 (which made it hard for a company to delist) were both repealed.

Nor has the NYSE shunned new technology. The Big Board's chairman, Dick Grasso, claims to have invested more in computers than any other exchange has. Indeed, in a reference to his upstart new rivals, he calls his own exchange the biggest "electronic communications network" (ECN) in the world. Over 90% of NYSE trades, he says, are now handled electronically. Three-quarters of all trades directly match buyers and sellers, with no spread for an intermediary. Only for the biggest trades does the exchange's system of "specialists", who have an exchange-sanctioned monopoly on market-making for each stock, come into play.

As for the floor, the NYSE not only plans to keep it: it wants to build an even bigger one at 30 Broad Street, for which it is seeking support from the city council. Mr Grasso jokes that he keeps all the paper around the place mainly to amuse his critics. He likes to tell the story of Seymour Cray, who was present when his eponymous computer maker was listed, and advised the exchange to cover up its floor to pretend that the trading was all high-tech. The real battle between exchanges, says Mr Grasso, is no longer about electronics, still less about floors against screens: it is about liquidity and price.

If he is right, the NYSE, as the world's biggest exchange, should enjoy all the natural advantages of any incumbent. Studies of trading costs at different exchanges conducted by Elkins McSherry, a research firm, suggest that the Big Board is one of the cheapest marketplaces in which to do business. Its overheads may be larger than those of rivals; but it more than makes up for this through "price improvement" (getting investors a better deal by exposing their orders to the floor) and greater liquidity. Another study of execution costs in different markets, conducted last year by the Securities and Exchange Commission (SEC), confirmed that, for most shares, the NYSE had lower costs than its arch-rival, Nasdaq—and, often, than the newer ECNs.

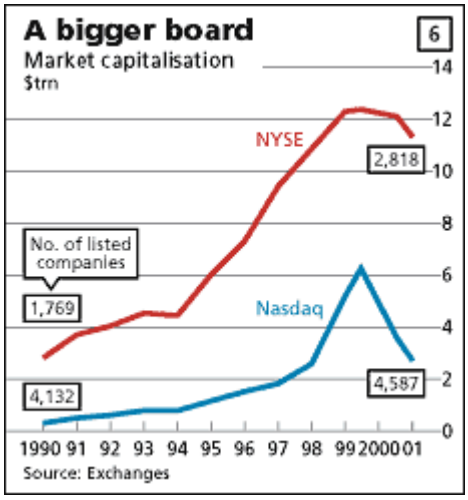
Nasdaq blues

The Nasdaq has had more than its share of troubles in the past few years. It was set up in the 1970s when the NYSE allowed no IPOs; that is why Nasdaq became the market of choice for new-technology companies such as Microsoft and Intel. Unlike the NYSE, which is essentially an auction or order-driven market, the Nasdaq is mainly a dealer- or quote-driven market, meaning that dealers quote prices at which they are prepared to buy or sell. That makes Nasdaq unique among the world's biggest exchanges; London, which in 1986 adopted the Nasdaq approach as the closest to its old jobber/broker model, has since abandoned the quote-driven market in favour of a continuous electronic auction.

Although dealer markets are said to be better at handling large trades, the evidence of the marketplace now suggests that continuous auctions with an open order book do a superior job at lower cost. ECNs have won business from the Nasdaq by offering just such an electronic order-driven system. A dealer system is better for intermediaries, who can maximise spreads, than for investors, who in an order-driven system have the chance of cutting out the spread altogether. Worse, in a dealer system there is a risk of collusion among market-makers to keep spreads wide.

The SEC has successfully pursued cases against Nasdaq dealers for collusion, partly on the basis of questionable academic evidence that purported to show that prices moved suspiciously more often in eighths than sixteenths. The NYSE went fully decimal (ie, its prices are now quoted to the nearest cent, instead of the nearest sixteenth) last January, a feat the Nasdaq managed only in April, just ahead of a deadline set for the change by the SEC.

It is also notable that the competition from low-cost ECNs, such as Instinet (owned by Reuters), Island and Archipelago has been more serious against the Nasdaq than against the NYSE. Some 30% of trading in Nasdaq stocks now takes place outside its organised market, against less than 5% for the NYSE. The Nasdaq is fighting back with the introduction of its "SuperMontage" system, which will pull together all quotes to ensure that investors get the best price, but it will find it hard to beat the ECNs on cost.



As if to cap all these troubles, the past year has seen the deflation of the great Nasdaq/TMT bubble. In the 1990s, the Nasdaq became almost synonymous with the great bull market. Remember those stories of frenzied online day-traders? Most had no knowledge at all about their chosen companies (sometimes to the point of not even knowing what they did) and relied for stock tips and news on Internet chat rooms. Not surprisingly, most have disappeared as the Nasdaq has deflated, pulling down the broader bull market and also raising questions about the equity culture itself. And although exchanges insist that bear markets can be as busy (and profitable) as bull markets, they tend to translate into fewer trades and less money for exchanges.

Yet Frank Zarb, Nasdaq's chairman, remains ebullient. Like Mr Grasso, he believes that the secular forces driving America's (and the world's) conversion to an equity culture will outlive a bear market: indeed a correction has its uses, because it reminds investors of the link between risk and return. On the SEC study of relative trading costs, he notes that, in the few cases where there is head-to-head competition between his exchange and the NYSE (ie, for large-capital stocks), Nasdaq actually came out cheaper. As for the ECNs and other "alternative trading systems", he welcomes competition—so long as the playing-field is level, and so long as it does not lead to damaging fragmentation.

Can competition between exchanges be harmful? This is one of the theological questions that most divides practitioners around the world. Mr Grasso, like most bosses of established exchanges, talks sourly of trading systems that are parasitical free-riders on the NYSE's price information, which is available free of charge. He is increasingly unwilling to subsidise the inter-market trading system that, in effect, keeps America's remaining regional exchanges alive by allowing them to trade freely using NYSE data. Plenty of exchanges also sound warnings about the danger of a fragmentation of liquidity that could damage the process of price formation. This, they say, is why they are more like public utilities than private markets, and why they were, until recently, permitted to maintain so many restrictive practices. Such practices were, you see, for the good of investors, not for the exchanges.

Yet a combination of new technology and deregulation has blown such protectionist twaddle out of the

water. Stock exchanges, it has become clear, are not public utilities at all: they are money-making enterprises. Moreover, market forces are also proving good at dispelling any fears of fragmentation. In principle, there is no reason why competition should diminish liquidity; the great virtue of computer technology is that it makes it simple to link together different pools of liquidity to avoid this. Besides, liquidity in a market will tend naturally to collect in one location (which is what should give incumbents their strongest advantage). Meanwhile, now that most, if not all, restrictive practices at exchanges are on the way out, market forces can surely be relied on to drive trading costs down.

That may well, in the end, be bad for both the NYSE and the Nasdaq. As Benn Steil, an analyst at the Council on Foreign Relations, puts it, “The economics of the exchanges are being unravelled.” Once an electronic trading network has been put in place, the marginal cost of additional transactions is, in effect, zero. The arrival of e-brokers that can automatically search out the lowest-cost market for their clients adds to the pressure. How can a high-cost marketplace ever hope to compete in these circumstances?

There are three answers. The first is to rely on inertia. All the established exchanges benefit from the reluctance of many investors and brokers to change their trading places. The second, and more important, is high liquidity. Once a market has captured most of the trading volume in equities, it can reap economies of scale that enable it to see off even a potentially low-cost rival, and its grip on liquidity then becomes self-reinforcing. This is clearly the NYSE’s secret: its apparently low trading costs reflect the fact that its high cost base is spread over enormous volumes.

But the third answer is more brutal: to rig the market in some way. In practice, few investors, even among institutions, are fully aware of the true costs of trading, since they are bundled up in their overall charges. The SEC study on execution costs concluded that as many as 85% of equity transactions were not carried out at “best prices”. Yet that may be because investors prefer immediacy of execution to marginal price improvement. Kenny Pasternak, boss of Knight Securities, which is the biggest market-maker on the Nasdaq, says his deals are done in seconds, as opposed to several minutes on the NYSE.

However, there are other, less respectable factors at work. One is the practice of payment for order flow, under which ECNs pay brokers a kick-back of a few cents for every order sent their way. Knight does this too. Not surprisingly, the established exchanges would like to ban payment for order flow, or at least make sure the customers know what is going on. But they themselves often benefit from “soft commissions”, a term that embraces the provision of research, computer terminals and other goodies by investment-banking intermediaries to institutions, in exchange for their business—which is then normally carried out on the NYSE or Nasdaq.

Then there is the value of the information contained in customer orders. Nothing so crude as “front-running” (putting through your own orders before your customers’, so that you benefit from any price effect), to be sure; but knowing about the direction and magnitude of orders can be crucially important to any firm’s proprietary trading. Mr Steil is harsh about the length of time it takes to put through an order at the NYSE: “Price improvement is just another name for front-running”, he says. NYSE specialists’ enviable profitability seems to be linked largely to their knowledge of order flow.

The great levellers

What can be done to prevent market abuses and ensure that the playing-field is indeed level? The answer is mainly in the hands of the regulators, and particularly the SEC. Arthur Levitt, who was chairman of the SEC throughout the Clinton presidency, devoted much time to improving standards of disclosure and transparency in the equity markets. From the start of this year, the SEC has required brokers to tell investors on which markets their orders have been executed and whether any payment was made for them. Yet regulators may not be enough, on their own, to ensure fair competition. And there are plenty of suspicions that ultimately the SEC is not willing to jeopardise the NYSE’s and the Nasdaq’s position; it is keen to keep out foreign competitors’ trading screens, for example, and has not yet licensed any ECN to operate as a full exchange.

The most important players in the game are not, however, the regulators, the investing institutions, the exchanges or even the ECNs. They are the big investment banks such as Merrill Lynch, Morgan Stanley and Goldman Sachs, which act as intermediaries between investors and exchanges, and so handle most of the order flow. They employ most of the well-known equity researchers. They are powerful members of the exchanges. They derive huge fees from underwriting IPOs and other new equity issues, as well as from arranging mergers. And they run large proprietary trading operations.

The investment banks had some fantastic years during the bull market—reflected in fantastic salaries and bonuses for their traders. But, perhaps because the staff have proved so adept at creaming off profits that might otherwise have gone to shareholders, they are now under pressure. Consolidation has become the fashion: in 2000, CSFB bought Donaldson Lufkin Jenrette, UBS Warburg acquired Paine Webber and Chase Manhattan took over J.P. Morgan. Rumour has predators circling Merrill Lynch or Lehman Brothers. The bear market has also started a round of lay-offs in the industry.

Investment banks are also suffering from a reputation for being “conflicted”. This is clearest in such areas as trading on their own account while also acting on behalf of investors—two activities that, at one time, were separated into stockjobbing and stockbroking precisely in order to avoid conflicts. There is the much-publicised conflict between independent equity research and the handling of IPOs or mergers for client companies. Bankers insist that they maintain strict Chinese walls to avoid conflicts of interest. But Robert Pozen, head of Fidelity, one of America’s biggest institutional investors, is not alone when he complains that less than 1% of investment-bank equity research comes with a “sell” recommendation. Now that a bear market has arrived, plenty of sell-side analysts look foolish.

Live and let live

The conflicts extend also to the banks’ love-hate relationship with the exchanges, and particularly with the NYSE. Goldman Sachs, for instance, has long been a critic of the exchange for its hidebound practices, and has been careful to invest in several rival ECNs to keep its options open. But more recently Goldman seems to have tacked back, by buying two firms of NYSE specialists, including one of the biggest, Spear, Leeds & Kellog. This is more a case of “if you can’t beat ‘em, join ‘em”. In the past, Goldman has been critical of the monopoly privileges of specialists. Even fans of the Big Board find their role hard to justify. But with the exchange keeping such a firm grip on its market share, the specialist firms have been highly profitable—and they hold unrivalled information about order flow.

Not that Goldman, or anybody else, would dream of exploiting any such information. Yet Goldman’s interest in Spear, Leeds & Kellog is not simply about profits or even technology. It also says something else about the big investment banks: that they see themselves as the biggest potential rivals to the exchanges. They are, for instance, keen to internalise orders, by offsetting one transaction against another—a practice that is of obvious benefit to an intermediary, if not to its clients. Charles Schwab, a big discount broker, also likes to internalise orders.

The NYSE and the Nasdaq are, in short, not without competition, even from among their own members. They insist that they are responding to that competition as any business would—by cost-cutting, better marketing, fighting hard to preserve market share and so on. Yet they are handicapped in one further way: whatever they pretend, they are not in fact structured like businesses at all. They are, rather, mutually owned members’ clubs. That means they are beholden to special interests—the NYSE to the floor traders and specialists that its critics would like to get rid of, the Nasdaq to its broker-dealer firms.

Both exchanges, it is true, have talked vaguely of demutualising and becoming proper publicly traded companies (just as they have also talked, even more vaguely, about a possible merger between themselves, so that they can jointly fend off the ECNs). But for the NYSE, at least, such plans are, as Mr Grasso puts it, “on the back burner”—ie, unlikely to proceed. The Nasdaq recently sold a chunk of convertible debt to a private buyout firm; but even so it still has some way to go before it becomes a separate public company. This makes the American exchanges quite unlike another potential set of rivals: the European stock exchanges, which have been falling over themselves to become public limited-liability companies. As the equity culture goes global, so, increasingly, will the equity business. The Europeans could then become the biggest threat of all to the American leaders—if only they could sort out their act in Europe first.

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The battle of the bourses

May 3rd 2001
From The Economist print edition

Europe has been slow to rationalise its stock exchanges

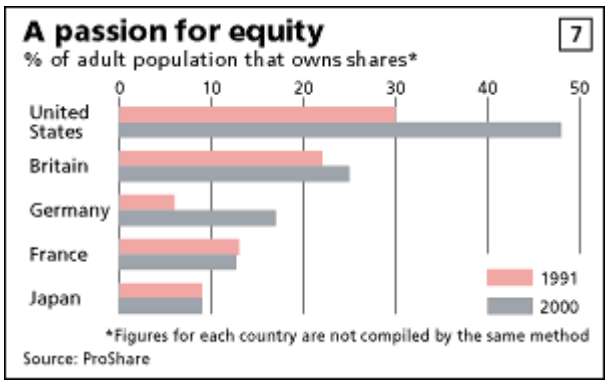
HOW many exchanges does the European Union, with its much-ballyhooed single financial market, actually need? Nobody knows the answer, but it must be fewer than the 30 or so that it has today (counting derivatives as well as stock exchanges). So much has, however, been clear for a long time. Nearly 15 years ago, Europe's bourses first talked of setting up joint ventures, such as Pipe and Euroquote, which might have been forerunners of a single European equity market. But such attempts have come to nothing. Rüdiger von Rosen, now boss of the German shareholders' institute but at the time head of the Frankfurt exchange, sadly recalls a meeting in Copenhagen in mid-1991 at which the last rites for Euroquote were read, over many beers.

Yet the pressure to tidy up Europe's patchwork of exchanges has, if anything, increased, for three reasons. The biggest is the rapid spread of an equity culture across the continent. Britain has long had such a culture: indeed, it was its own George Ross Goobey, as head of Imperial Tobacco's pension fund in the 1950s, who first pioneered the "cult of the equity". But even in Britain, investor interest was stimulated by the Tories' privatisations in the 1980s and 1990s. Efforts to foster share ownership through tax relief, and by encouraging people to take out private pensions, have also had an impact.

More striking still, over the past decade, has been the development of an equity culture in Germany, France and across much of the rest of the continent. In Germany, for instance, investors used to put almost all their savings into banks or bonds. The seminal moment in converting them to equity, says Mr von Rosen, was the first privatisation of Deutsche Telekom in November 1996. In the four-and-a-half years since then, there have been more IPOs than in the previous 50 years put together. Germany now boasts 10,000 investment clubs and a host of investment magazines. Bosses of DWS, the country's biggest fund manager, say that in the 1980s they put 10% of their assets into equities; now the proportion is more like 50-55%, and rising.

In France, similarly, big fund managers such as Axa are putting far more of their money into shares. There are even the beginnings of a thriving private-equity (venture-capital) business. French bankers date the origins of new French interest in shares to the Loi Monory of 1978, which offered tax reliefs for equity investment. President Mitterrand's nationalisations of the early 1980s interrupted things, but when they were reversed in the 1990s, the upward trend in share ownership in France resumed. As in Germany, private pension funds are also growing fast, even if the phrase remains taboo in France because it sounds too Anglo-Saxon.

Now nearly a fifth of the adult population in Germany own shares (see chart 7). A similar upsurge has taken place in other European countries, with Scandinavia and the Netherlands somewhat ahead and France and the southern European countries still behind. Patterns of saving have changed. Mutual funds, in particular, have boomed over the past five years. And they are increasingly turning to equities: in 2000, according to Morgan Stanley, the equity weighting of European mutual funds rose from 36% to 49%. There is scope for more: bonds still represent nearly a quarter of European mutual-fund assets, compared with only 11% in America.



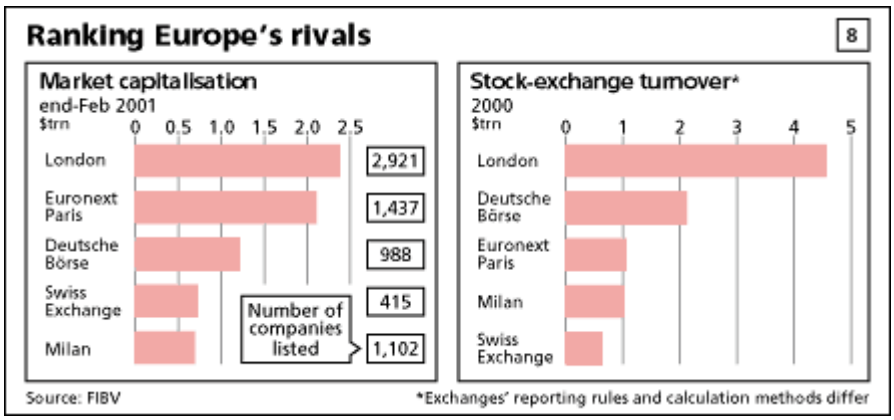
This new European equity culture is now likely to be severely tested by the first bear market that new investors have ever encountered. The past year's decline in the shares of privatised Deutsche Telekom and France Telecom will have been particularly distressing. So has the recent experience of the Neuer Markt, Germany's high-tech second market, which has been replicated in other secondary markets across Europe, slowing down these countries' nascent venture-capital industries. Yet so far few German or French investors seem to be ready to give up on equities altogether and return to bonds. This means that demand for more efficient stockmarkets, and especially for cheaper and better cross-border trading, will grow.

The second source of renewed pressure for consolidation among Europe's stock exchanges has been the arrival of the euro. Even before the single currency was born in January 1999, a single European financial market was supposed to be in place, but it has always been more of a myth than a reality. Now that investors and companies in the euro area face no currency risk, however, sticking to national stockmarkets, either for saving or for raising capital, seems increasingly anachronistic. Paul Roy, of Merrill Lynch, reckons that in 1997 only 22% of his clients made equity investment decisions in Europe on a sectoral rather than a national basis; last year the sectoral approach accounted for 67%.

The potential gains from a fully integrated European capital market are mouthwatering. The European Commission's first estimates for the benefits from its 1992 single-market programme suggested that Europe-wide GDP might rise by as much as 0.5%. A sizeable chunk of that increase was expected to come from financial services. A unified capital market remains a key source of the potential benefits from monetary union. Over the past 15 years, American pension funds, free of all investment restrictions, made average annual returns of 10.5%, compared with only 6.7% for European pension funds, which are subject to tight regulations over asset classes and local-currency exposure. To catch up with the Americans may require not just abolition of such regulations, but also a closer integration of equity markets across Europe.

The third thing that is pushing Europe's stock exchanges together, inevitably, is competition. In contrast to America, ECNs and alternative trading systems have so far pinched little business from the established stock exchanges, mainly because the incumbents too have developed order-driven electronic trading. But the threat is growing. And meanwhile the battle for business among the exchanges themselves is intensifying. The prize they are all going for is a single European marketplace for blue-chip stocks, rather along the lines of the New York Stock Exchange. Everybody agrees that investors and companies alike want such a market. But nobody can agree on how it should be created.

There have been several solo attempts to build a Europe-wide market. After Big Bang in 1986, the London Stock Exchange renamed itself the International Stock Exchange and created a special market, SEAQ (International), which grabbed big chunks of trading in European blue chips from sleepy continental bourses. But nationalism and protection play as big a part in the equity business as in airlines. Europe's governments were not content to sit idly by as London hoovered up "their" business, so they belatedly reformed their bourses to make them more competitive. As a result, exchanges all round Europe became more efficient, and trading in most domestic equities was repatriated from London.



The next obvious ploy to try was for the exchanges to construct a joint platform for trading the biggest European securities. The pioneers were the derivatives exchanges: France's Matif forged a somewhat tenuous link with Germany's Deutsche Terminbörse, and later the DTB itself merged with its Swiss counterpart to form Eurex. Eurex, a screen-based exchange, did so well that it became the world's biggest derivatives exchange, taking over from the floor-based Chicago Board of Trade. Along the way Eurex unceremoniously demolished the European leadership of London's floor-based Liffe, which lost its near-monopoly in the German bund futures contract in a matter of months. Europe's stock exchanges noted that episode carefully.

Even so, most attempts to forge cross-border links among stock exchanges have failed. The French and Germans tried half-heartedly to join forces in the mid-1990s. In 1998 the two biggest exchanges, London and the Deutsche Börse, announced an alliance. The Paris bourse was furious at being left out. After much politicking, it and five other exchanges joined the British and the Germans in an eight-way link-up. Yet this alliance too fell apart. In the spring of 2000, the London Stock Exchange and Deutsche Börse announced a full-blown merger to form a new exchange, to be called iX. They even signed up America's Nasdaq in a planned venture to form a joint high-tech market. In response to this new competitive threat, Paris swiftly signed up Brussels and Amsterdam into a joint grouping to be called Euronext.

But the story of iX was to be even unhappier than previous episodes. On each side there were claims that one exchange had sold out to the other. London brokers who had invested a lot to adopt the exchange's SETS trading system were furious to be told they would now have to switch to Frankfurt's Xetra system. The plan was also beset by regulatory uncertainty. Politicians and small shareholders were dissatisfied. A lot thought (correctly) that iX had been dreamt up by the big investment banks, many of them American, largely for their own benefit.

The next chapter was the most extraordinary of the whole tale: the Swedish-based OM Group, operator of the much smaller Stockholm stock exchange, launched a hostile bid for the London Stock Exchange. After some debate, shareholders in the exchange decided to reject both that bid and the iX merger, the exchange shed its chief executive, Gavin Casey, and everything went back to square one. Ironically, Euronext, which was conceived in large part as a reaction to iX, has now taken shape, even though it has so far operated essentially as three exchanges under a single umbrella, rather than one.

Meanwhile the ECNs have not been standing still. Instinet is already active around Europe. Tradepoint, which was set up as a rival to the London Stock Exchange in 1992, struggled for years but then attracted some powerful bank shareholders and is now a recognised exchange. It has this year embarked on a joint venture with the Swiss Stock Exchange, called virt-X. Antoinette Hunziker-Ebneter, virt-X's chief executive, is confident that the new exchange, with its existing base of big Swiss companies, will do far better than previous ECNs. Virt-X plans to launch a Europe-wide market for blue-chip equities in June. One of its selling-points over London will be avoidance of stamp duty, which remains in place for British share trades despite frenzied lobbying against it by the London exchange.

Other plans are on the drawing board. Morgan Stanley and OM have launched Jiway, a new exchange through which retail investors can invest in European blue chips. America's Nasdaq, which wanted a piece of the iX action, is prowling around afresh now that iX has failed. It has taken a large stake in Easdaq, a sort of European equivalent to Nasdaq that was largely moribund until Knight Securities took an interest in it. Ironically, Knight now occupies the old trading floor in the London Stock Exchange's building—which the exchange plans soon to vacate entirely.

Exchanges plc, GmbH and sa

All these manoeuvrings have brought about two key changes in Europe. First, competition has pushed all the exchanges into modernising and investing in technology, so that their trading systems are now electronic, order-driven and efficient. Indeed, the exchanges are so proud of their technology that they are touting for other business: the Deutsche Börse's Xetra system handles trading for exchanges in Austria, Ireland and Finland, and London's SETS is about to do the same for Johannesburg. Indeed, rivalry among Europe's stock exchanges is now more about trading technology than anything else. The efficiency of the big European exchanges' trading platforms is a big reason why the ECNs have found it hard to break into the market.

Second, and perhaps more significant, the exchanges have recognised that, faced with the need to respond commercially to competitors, they needed to become traded companies themselves. The Swedes led the way with the flotation of their stock exchange, which is now part of OM. Deutsche Börse is now listed and traded (Werner Seifert, Deutsche Börse's chief executive, is proud that his is the only exchange that, albeit briefly, went to a premium above its issue price). London has demutualised and limited trading in its shares takes place: it plans a full public listing later this year. Euronext also plans an IPO this summer.

There are three arguments in favour of publicly traded stock exchanges. One is that flotation resolves the problem of the exchanges' governance: instead of being cumbersome bodies answerable to the vested interests of their members, the exchanges' managers, like bosses of other companies, have to deliver results to shareholders. Second, flotation removes the presumption that exchanges occupy some special national position that merits protection against competition from new upstarts, whether through political or regulatory support or via their membership. And third, it increases the chance that one exchange can take over another (although the failure of OM's hostile bid for London suggests that takeovers will seldom be easy).

America in the dark

Where does this leave the two big American exchanges, which seem in no hurry to follow suit? "In the dark," opines Deutsche Börse's Mr Seifert. Don Cruickshank, chairman of the London Stock Exchange, echoes this view. He says he is prepared to talk to anybody about the future, but only so long as they too have to face the discipline that comes from being traded on the capital market. Yet London and Frankfurt no longer seem to be talking to each other, partly because the Germans are seeking to enforce a contractual clause that would make London compensate them for the failed merger. With Euronext bedding down its merger, the two biggest exchanges in Europe seem both to have lost their way—though the arrival of a new chief executive in London, Clara Furse, may soon change that.

As for the Americans, they may be in the dark, but they still matter. They are the model for other countries' burgeoning equity cultures. They control the biggest capital market in the world, which is why so many European companies have chosen to list in America. And a bigger dream still is emerging on the horizon, once Europe sorts out its own internal structure: of a global equity market, to serve a global equity culture. In any such market, both the NYSE and the Nasdaq would play a key role.

The third leg to such a global equity market would have to be the Japanese stockmarket, and later perhaps some of the biggest emerging markets. Japan is worth some study, for one big reason: it has had long experience of a grim bear market. This has clearly impeded the growth of an equity culture in Japan. Yet in the long term Matsuo Tsichida, the Tokyo Stock Exchange's chairman, remains optimistic. The demographic and pension pressures facing Japan are even worse than those in prospect in Europe. Alternatives to equity investment are unattractive because yields are so low. It is notable that even in the 1990s bear market the number of individuals owning shares in Japan has risen. And on some measures the Tokyo market now looks cheap.

The Tokyo Stock Exchange has also modernised considerably. Fixed commissions went in 1999, the same year that the trading floor was closed. Trading is now by continuous electronic auction. ECNs have yet to make inroads in Japan, but the Tokyo exchange is ready to battle against them. It is even in the throes of considering demutualising and becoming a listed company. Mr Tsichida is keen that Tokyo should play a big role in any global equity market. His ambition now is to attract mainland Asian companies, making Tokyo the regional market of choice. But he will have to compete not just against other developed markets such as Hong Kong and Singapore, but also against Shanghai, which after unifying its share structure will soon be the biggest Asian equity market.

The rise of China is sure to have a big effect on plans to create a global equity market. But before considering them further, a closer look is needed at one other aspect of equity trading. All those discussions in Europe have led to the discovery, pretty late in the day, that the main obstacle to increased cross-border equity trading (and so to a putative global market) does not lie in the trading platforms of the exchanges at all, but in the usually boring business of clearing and settlement of trades. In Europe, this can cost ten times as much as it does in America. Now, belatedly, European financiers are seeking to do something about it—but they are running into big obstacles.

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Paper tigers

May 3rd 2001
From The Economist print edition

Why the back office often costs more than the front

AMID all the enthusiasm for the rise of equity markets and for a new global equity culture, it is easy to overlook the infrastructure of share trading; yet the ease and the cost of buying and selling shares are crucial factors in how far and how fast such a culture takes root. As we have seen, stock exchanges in both America and Europe could do with some reforms on both these scores. But the biggest obstacles in Europe are stored up in the back office.

In equity trading, especially the international sort, it is the back office that often accounts for a surprisingly large chunk of the costs. When an investor buys a share, he may believe that the only thing to worry about is the cost of commission and the spread he pays to his stockbroker. But the trade has to be confirmed. It has to be cleared, a cumbersome business given that equities constitute a stake in a company, so any change of ownership has to be registered. And the whole deal must be settled, with money changing hands.

In Europe, three huge problems loom over this whole process. The first is that clearing and settlement, like so much of the rest of the equity business, are havens of vested interests and restrictive practices. The second is that the systems have been designed for national, not international use. And the third is that, because clearing and settlement seem so boring, the business has been largely neglected not only by investors but also by traders, bankers and regulators. They have tended to focus instead on the wrong part of the picture: the stock exchanges' trading platforms, which are in fact quite efficient in Europe.

In this respect, at least, it is the Americans who have shown the way. Their exchanges may still be stuck in the dark ages (or at least that is what the Europeans say); but their clearing and settlement systems are state of the art. In the late 1970s, America had as many as seven separate clearing and settlement organisations. New York was notorious for its "paper blockages", and from time to time the markets would have to close in order to allow everybody to catch up on the paperwork. To resolve these problems, the various groups were cobbled together into one body, which has since become the Depository Trust and Clearing Corporation.

The DTCC, which is mutually owned by its member banks, now handles the clearing and settlement of almost all American security trades. It acts as the central counterparty (CCP) for all shares traded on both the NYSE and the Nasdaq, and registers changes of ownership. Thanks to the DTCC, share certificates in America no longer physically change hands and registrars are out of a job. And its costs are low, at five cents for an average equity trade, whereas the European average is nearly ten times as much.

Even so, the DTCC will have to run hard merely to keep up with volumes. It has to be able to cope with the peaks in business, and those peaks are getting ever more vertiginous. On its busiest day in 1998, it handled some 6.3m securities trades; only three years later, trading on the peak day had risen to over 18m, worth a gross total of $722 billion. The volume of actual settlements is kept down by "netting": of that $722 billion, for example, only $22 billion had to be settled, after offsetting debits and credits. Yet Jill Considine, the DTCC's boss, says it is no longer fanciful to talk of capacity constraints.

Of silos and hourglasses

Japan has sensibly adopted a model similar to America's, with a single clearing and settlement

organisation, albeit one that is owned by the Tokyo Stock Exchange. But the capacity constraints in Europe are far more obvious. The continent has as many as 30 clearing and settlement organisations. Links between them are poor or non-existent. Settlement dates are not compatible: some settle one or two days after trades (known as T+1 or T+2), others take much longer. Worse still, attempts to improve the system and its cross-border co-ordination have so far failed to do much good.

The London Stock Exchange, for example, decided soon after Big Bang to embark on the task of speeding up settlement (then done on a rolling fortnightly basis). It devised a scheme called Taurus that was to dematerialise share certificates and bring in wholly paperless settlement. But the project's cost ran out of control, and there was resistance to change from bank registrars, who were making a comfortable living out of the existing system. As so often when there is trouble in Throgmorton Street, the exchange parted company with its chief executive, Peter Rawlins. Soon afterwards it lost responsibility for settlement altogether, to a new organisation called Crest.

That loss turned out to be no bad thing. In continental Europe, the bourses retained ownership of their domestic clearing and settlement organisations, while the banks owned the two international bodies that handled cross-border business, Euroclear and Clearstream (formerly Cedel). Yet this ownership structure is now one of the biggest impediments to change.

What needs to be done? The most urgent requirement is to have a Europe-wide CCP. The London Stock Exchange and Euronext now have CCPs of their own. Since February this year, the former has been using the London Clearing House, which works closely with (and may one day merge with) Crest, and the three Euronext members use Clearnet, a joint venture between Euroclear and the French clearing and settlement agency, Sicovam. The Deutsche Börse has plans to use Clearstream, in which it has half-ownership. The trouble is that none of these three clearing and settlement groups relates all that easily to any of the others.

The European Securities Forum, a body set up by the big banks to campaign for a European CCP that would maximise the scope for netting, looks to the DTCC as a model of what Europe needs. It cannot be replicated exactly, if only because Europe has neither a single legal system nor a single regulator. But, at least in theory, it should be possible to push together Clearnet, Clearstream, Crest and the LCH, either through a formal merger or by making them "interoperable" (the buzzword of the moment).

The trouble is that those vested interests get in the way. Now that Europe's stock exchanges are becoming publicly traded companies, they relish the revenue streams that are brought in by their clearing and settlement arms. After all, the higher cost of clearing and settlement in Europe compared with America translates into higher income for those that operate the system. The upshot is that Europe's exchanges are now more reluctant than they were to shed their clearing and settlement arms.

The DTCC's Ms Considine comments mildly that she does not like the notion of an exchange owning its clearing organisation. Pen Kent of the European Securities Forum shares that view. He deplores the building of such vertical "silos", and suspects that there is scope for cross-subsidy between the clearing and settlement arms (which have a national monopoly) and the trading systems (which do not). Setting up a Europe-wide CCP does not sit well with the silo model, says Mr Kent, because it has all the characteristics of a public utility, and perhaps even of a regulated monopoly.

It would be better to have a single public body in Europe to act as a CCP and deal with trade clearing, even if there were more than one settlement organisation. This is known as the "hourglass" model, in contrast to the continent's silos. It would have competing trading platforms at the top, a single CCP in the middle to maximise the scope for netting, and maybe two or three settlement bodies at the bottom. But, partly because Europe's exchanges are becoming publicly quoted companies, the transition from silo to hourglass will be hard.

Don Cruickshank, chairman of the London Stock Exchange, hopes that the European competition authorities might look into the subject to ensure not just interoperability but fully equal access. As a former telecoms regulator, he likens the system to one in which a regulator may have to ensure that an incumbent telephone monopoly offers its competitors fair and correctly priced access to its wires. The recent Lamfalussy report on the regulation of Europe's securities markets agrees, and hints that, unless the markets resolve the situation satisfactorily, governments may have to act to cure Europe's clearing and settlement ills. They might even have to impose a ban on exchanges owning clearing and settlement organisations. Since the German and French exchanges disagree with the entire diagnosis, there may well be a need for some intervention.

Globalism rules?

What about the global market? If there is a case for one CCP in Europe, or at the very least for a system of interoperability, there is one on a world level too. As if to demonstrate the strength of interest in this subject, the first-ever world conference on CCPs was held earlier this year under the auspices of the DTCC, in London. It was sold out within days.

Right on cue, the Group of 30, a high-level industry think-tank, has set up a committee under Sir Andrew Large, a former securities regulator who is now at Barclays Bank, to look into clearing and settlement on a global level. Sir Andrew does not tout a single global clearing and settlement organisation: that might be a monopoly too far. Nor does Ms Considine, who is also on his committee. Instead, both talk of using the three natural time-zones to spread the volumes, and thereby provide, if not competition, then at least some scope for benchmarking. The committee may also delve into such matters as speeding up trades, to T+1 everywhere, and even ultimately to delivery-versus-payment (DVP), the model that the foreign-exchange market is moving towards.

Does the world want a global equity market? Plenty of bankers and traders think it is moving in that direction. The favoured idea is a single trading platform (or two or three linked platforms) on which all of the world's blue-chip equities can be traded, with a similarly consolidated back office. After all, the foreign-exchange and American Treasury-bond markets trade more or less continuously round the clock. Why not shares in, say, GM, Volkswagen and Toyota as well?

It is a seductive idea, and one that stock exchanges are working towards. Last year the New York Stock Exchange, Euronext and the Tokyo Stock Exchange announced the formation of a global equity market (GEM). Other exchanges, including Australia's, Hong Kong's, Mexico's and Brazil's, were quick to sign up. Mr Grasso, who uses the analogy of airline code-sharing for the GEM, recently announced plans for a pilot programme trading its stocks on its partners' exchanges, starting with Asia.

The then planned iX touted a similar global marketplace via its linkage to Nasdaq, which also operates in Japan and has just relaunched Easdaq as Nasdaq (Europe). Nasdaq remains interested in links with the London and Frankfurt exchanges, if only to rival the NYSE's GEM. There are precedents for global marketplaces in the securities business, notably Globex, which tried to hook up derivatives exchanges around the world to allow trading books to be passed around with the sun.

Yet for now, at least, a true global equity market is, as one banker puts it, "pie in the sky". Most equity investing remains stubbornly local: even in America, for example, there is a geographical bias towards local companies. As much as 95% of American equity investment is domestic, although the burgeoning ADR market is introducing more investors to foreign companies. The figures are similar in other countries. The bear market is unlikely to encourage more foreign venturing. And if Europe cannot rationalise its own nationalist-minded exchanges, what chance is there of doing anything meaningful at a global level?

Even so, the demand for something worldwide in scope is likely to grow. Investing institutions, investment banks and companies are increasingly global. The spreading world equity culture is oblivious to national boundaries. Companies that sell in many markets are waking up to the virtues of having shareholders spread across those markets; a few are even looking for foreigners to sit on their boards. And technology is pushing in the same direction: if stock exchanges do not provide a global service, plenty of ECNs would love to try. After all, access to an e-broker trading on the Internet is global by definition: screens can be anywhere.

There is, however, another possible problem lurking in the wings: regulation. Already regulatory differences are complicating the task of creating a single European equity market. These difficulties are bound to multiply in any effort to construct some form of global market. And although regulators (and governments) are doing their best to keep up with capital markets that nowadays stretch across borders, the suspicion must be that they will tend to lag behind. The article looks more closely at the regulation of the equity markets and the way it affects the world equity culture.

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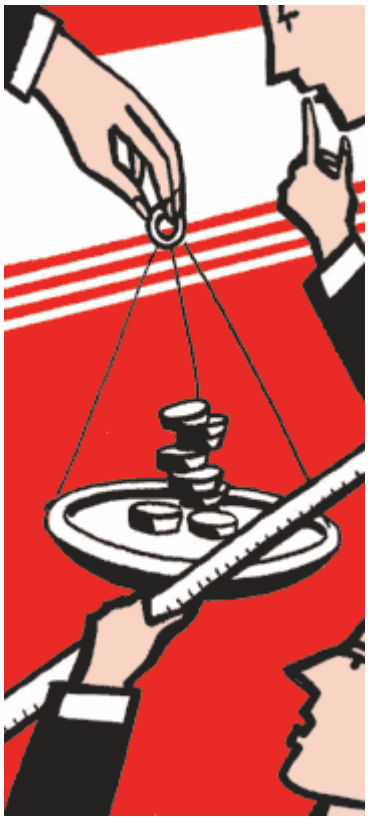
Regulators' arbitrage

May 3rd 2001
From The Economist print edition

Markets are evolving faster than regulators



CAPITAL markets, including equity markets, are much like other markets, save perhaps for two characteristics: their speed and their regulation. They react all but instantaneously to changes in supply and demand, which is one reason why they can be so volatile. And both they and those who operate in them are overseen by a complicated mishmash of government rules and regulations, designed (at least purportedly) to protect investors. As the number of investors grows, this job assumes increasing significance.

As ever, America was the pioneer. The Securities and Exchange Commission was set up as long ago as 1934, with the legal remit of supervising and policing not just stock exchanges but all the public capital markets. Like all regulators, it operated with and through the established exchanges, especially the NYSE, which retained a large self-regulatory role. The SEC has formidable investigatory powers and can levy substantial fines for infringements of its rules. Indeed, the amounts it collects in fines typically far exceed its (relatively high) operating costs.

Yet although the SEC remains the model to which other countries aspire, it has not always found that the course of regulation runs smooth. Not the least of the problems in America has been the hotch-potch of different regulators for different bits of the financial-services industry, mainly for reasons of history rather than deliberate strategy. For instance, banks may be supervised by the Federal Reserve or the Office of the Comptroller of the Currency (part of the Treasury) as well as state bank regulators. Deposit insurance is handled by a separate agency. Anybody involved in the equity business also has the SEC breathing down their necks. The derivatives markets are mostly regulated by the Commodities and Futures Trading Commission (CFTC). As for insurance, it remains regulated almost entirely at state level.

This higgledy-piggledy structure may have suited a time when, thanks partly to such laws as the Glass-Steagall act, financial institutions generally engaged in only one activity. But the scrapping of Glass-Steagall and the arrival of universal banks on the European model have blown it apart. Many of America's big banks now have to deal with several different regulators, which significantly increases their compliance costs. Citigroup, the biggest financial institution in America, has to satisfy not just several but hundreds of different regulators, because it is active right across the country in banking, securities, derivatives and insurance.

The SEC's long-standing chairman during the Clinton administration, Arthur Levitt, eschewed battles over the structure of American regulation, although his organisation has long wanted to take over the CFTC. Instead, Mr Levitt focused his attention on a basic question: what is regulation for? His answer was to put protection of individual investors at the top of the SEC's priorities so as to encourage the country's equity culture. His weapons were tough enforcement, greater transparency, full disclosure and spirited attacks on conflicts of interest. That did not always make him popular with the professionals. Despite his own background in the equity business, for instance, Mr Levitt was no friend of the NYSE, which he saw as hogtied by its own special interests. He would much prefer it to demutualise and become a public company, perhaps shedding its regulatory responsibilities along the way.

Elsewhere, Mr Levitt did not always get what he wanted either. His struggle to stop the accounting firms from offering consulting services to audit clients, for example, ended rather limply in a requirement for disclosure rather than a ban. He similarly failed to push through accounting changes that would have required companies to take the full cost of stock options into their income statements. And one of his last acts, known as Regulation FD, which requires companies to disclose market-sensitive information to everybody in the market, preventing them from discreetly briefing analysts, remains highly unpopular on

Wall Street. Mr Levitt had made it clear that he was worried about conflicts of interest within investment banks—and especially about the compromising of analysts' research by pressure from banks' mergers-and-acquisitions teams.

It is a pity that Mr Levitt made no attempt to sort out America's regulatory muddle, even so. True, he might not have been able to achieve much, if only because changes would require congressional approval, but at least he could have put the issue on the agenda. However, Phil Gramm, the Republican senator who chairs the Senate Banking Committee, and who had frequent clashes with Mr Levitt, rejects suggestions that America should adopt a single financial regulator. His principle, he says, is "first, do no harm". He sees no reason to change a system that does a good job supporting the country's equity culture. But the problem is not so much that the American regulatory system has not worked; it is that it costs too much and that it may not be well-suited to international regulatory co-operation, at a time when capital markets are going global.

In other countries, the regulatory picture remains mixed. For many years, most of them relied largely on their stock exchanges to regulate their markets, which were anyway relatively small. The message for the individual investor, who was often regarded as more trouble than he was worth, was *caveat emptor*. Until recently, for instance, insider trading was not illegal in much of continental Europe. Accounting standards, provisions for disclosure, transparency requirements, takeover rules, the permissible treatment of minority shareholders: all varied hugely between markets. And the agencies in charge varied a lot, too: they might be the exchanges themselves, or government ministries, or sometimes central banks.

More recently, countries have been learning a good deal from each other, not least because a growing equity culture has brought so many new investors into the marketplace. In 1997, Britain scrapped the cumbersome regulatory structure set up after the 1986 Big Bang. This had involved a string of self-regulatory bodies placed beneath a Securities and Investments Board that was, in essence, a weakish version of the SEC. It was replaced by an independent Financial Services Authority designed to regulate not only the securities business but banks and insurance as well. The FSA's chairman, Sir Howard Davies, has become a keen advocate of the case for a single financial regulator—though he has also, generously, conceded that the British approach is only one among many.

Still, there is now a discernible trend in financial regulation towards the British model. Most countries are coming round to the view that central banks should not be the regulators of commercial banks, partly because it might distract them from their main function of setting monetary policy and partly because a banking scandal might damage their reputation. Sweden, Australia, Ireland and the Netherlands, among others, have recently gone down the British route of setting up an autonomous single regulator for the entire financial-services industry. Japan too has its own FSA, though since its boss is a member of the cabinet, doubts must linger about its true independence. Earlier this year, the German federal government announced its own plans to set up a single financial regulator, although the Bundesbank and the German states are stoutly resisting any efforts to reduce their role.

Twin peaks

Besides America, only France and Italy, among rich countries, still insist on a separate regulator for banks and for the securities business. Michel Prada, head of France's stockmarket regulator, the COB, believes strongly in a "twin peaks" approach, the banking commission of the Bank of France being the other peak. He says the two regulators have different, and sometimes conflicting, objectives: his concern is protection of the investor, whereas the Bank's concern is with prudential regulation. He suggests that a single regulator would be blamed for every trivial financial scandal, making it less effective. He also argues that a large agency might be formidably difficult to manage. Whereas the COB employs just over 200 people, Britain's FSA has over 2,000.

These differences of style might be mere curiosities but for one thing: the globalisation of both the capital markets and the equity investor. Because both investors and intermediaries (and, as we have seen, stock exchanges themselves) increasingly operate across borders, regulators must do so too. That throws differences in regulatory structure into much sharper relief.

The regulators have responded in several different ways, most directly by drawing up the Basle rules on minimum standards of capital adequacy. The idea was to set common rules for how much capital internationally active banks should set against their risk-adjusted assets. The rules were first introduced in 1988 and have been updated several times since, for example to add capital charges for market risks

to those for credit risks. The latest revision has been sent out for final consultation, and is due to come into force in 2004.

The trouble with the Basle rules is that the weightings are crude, even misleading (for example, South Korea and Mexico are ranked with all other OECD countries for credit riskiness), which sometimes produces perverse effects. One beneficial effect, however, has been to encourage the growth of capital markets at the expense of bank financing. For firms operating in the securities business, there are no internationally agreed minimum capital standards, although most national regulators impose rules of their own (as does the EU, through its capital-adequacy directive). Efforts to negotiate Basle-like standards through IOSCO, the international body for securities regulators, have come to nothing.

Banks and securities firms have tended to trespass heavily on each others' territory, and most countries are now heading for a single financial regulator, so the differences in the treatment of banks and securities houses have become somewhat moot. But the Basle process also confers benefits in the shape of the constant exchange of information between bank regulators, which the capital markets miss out on, and for which they have tried to find substitutes. The past decade has seen a mushrooming of memoranda of understanding (MOUs) between regulators. But even MOUs may not be enough to cope with globalisation. How can the world manage, in the absence of a single, omniscient global regulator?

A Euro-SEC?

The problem is, inevitably, most acute inside the European Union, which is seeking to construct a single financial market even while retaining national regulators. So far, the results have been disappointing. Plenty of obstacles remain in the way of a true single financial market, especially at the retail level. For instance, several EU countries require their pension funds to invest largely in domestic government securities. In France, a recent tax break for equity investment was, extraordinarily, restricted to investment in French companies.

Earlier this year a committee of "wise men" under the chairmanship of Baron Alexandre Lamfalussy, a former head of the European Monetary Institute (the forerunner of the European Central Bank), issued a report on the regulation of European securities markets. The Lamfalussy report drew attention to the failure of the investment-services directive, passed in 1996, which was supposed to create a single securities market in the EU. It suggested a new streamlined legislative process that would revolve around the creation of a European regulators' committee and an EU securities committee, staffed by senior finance ministry officials. The Stockholm EU summit in March broadly endorsed the report.

Does this herald an EU-wide SEC? Mr Lamfalussy, an arch-federalist, says it might. But for the time being the appetite for any such body remains small. Although some continental bankers say that an EU-wide regulator would be a help, most fear that it would simply impose an additional layer of regulation, on top of the national ones. So long as legal systems and enforcement remain national and not supranational—which means, in effect, so long as there is no single EU government—the regulatory structure seems likely to remain largely national too.

A second reason for thinking that a Euro-SEC may be some way off is that, predictably, even the relatively mild Lamfalussy proposals are caught up in a typical power struggle between the European Commission, the Council of Ministers and the European Parliament. One senior regulator argues that the process of creating a single securities market in Europe would be smoother if the European institutions were kept out of it altogether.

And what about that bear market? It may well make regulators and governments busier, because more scandals and abuses tend to be uncovered when equity prices fall. A rising market, in contrast, disguises a variety of sins. Yet apart from that, there is no reason why regulators—or governments, for that matter—should have much of a stake in a bull as opposed to a bear market. Indeed, there is a strong argument against any such bias. One reason why the American bull market defied earlier efforts to talk it down was that investors persuaded themselves that the Fed would support equity prices by cutting interest rates as much as was necessary. Despite the markets' recent rally, the "Greenspan put", as it was once christened, now seems to have been over-optimistic. In the long run, that can only be good for the world's equity culture.

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Governing the modern corporation

May 3rd 2001
From The Economist print edition

The spread of share ownership will affect company management too

EQUITIES are not, of course, mere financial assets, to be compared only with such other assets as bonds or bank deposits. They are, as we have seen, much riskier than these. This is because equities represent the ownership of the company itself, rather than merely some claim to a company's cashflow, which is what most assets are. So the spread around the globe of share ownership, and of an equity culture, are bound to have implications for the running of those companies: in the jargon, for countries' systems of "corporate governance".

The awkward relationship between many dispersed shareholders on one hand and a single manager or group of managers on the other has been the subject of a vast economic literature, going back at least as far back as 1932, when Berle and Means published their classic book on the modern corporation. Since then there have been many attempts to deal with the "agency problem" (ie, the difficulty of ensuring that company managers will act in the interests of the shareholder owners for whom they are, in theory, supposed to be mere agents). And, as with the structure and regulation of equity markets, different countries have adopted different solutions.

Once again America, with both a much wider distribution of share ownership and the strong regulatory arm of the SEC, leads the way. It imposes legal constraints on companies' ability to override the interests of minority shareholders. It allows shareholders to join together to launch proxy battles (enabling groups of small shareholders to exercise substantial voting power at company meetings), and to bring class action suits against a company's management.

The government officially encourages investing institutions that are significant shareholders, such as pension funds and insurance companies, to vote on company resolutions at annual general meetings. Many of them also use their voting power to exert leverage over a company's management at other times. Boards of directors are under constant pressure to assert their independence vis-à-vis chief executives. And bosses are increasingly remunerated in either shares or stock options, in the hope that this will align their own incentives with the interests of their shareholders.

Above all, America more or less invented the use of the public equity markets to gain corporate control via takeover bids. It does not matter that takeover bids, especially hostile ones, are rarely mounted. Still less does it matter that they are rarely successful. What counts is that the managers of a publicly quoted company, and its board of directors, know that the company can become the subject of a takeover bid if they fail to perform.

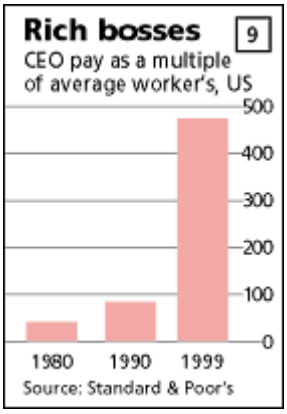
Yet there are plenty of complaints about the American system of corporate governance—and not just from well-known shareholder activists such as Robert Monks. Institutional shareholders are more likely to sell their shares—taking the "Wall Street walk"—than to invest time and money in trying to improve a company's management. The takeover threat has often been likened to the nuclear option: it is so

disruptive that it can be used only as a last resort, if a company's managers have gone way off course over a long period. Worse still, it can easily rebound on shareholders. Repeated studies have shown that, in most mergers, the shareholders of the acquiring company suffer, and that their loss is often greater than the gain for the shareholders of the acquired company. Indeed, many empire-building managers now indulge in takeovers in spite of, rather than because of, pressure from shareholders.

The boss is right

Meanwhile bosses have tilted the playing-field to benefit them in a variety of ways. They have made proxy fights more difficult to stage by putting obstacles in the way of shareholders communicating with each other. They have persuaded Congress to legislate to limit "frivolous" shareholder suits. Ironically, strict insider-dealing laws, meant to protect the interests of investors, have also made it more difficult for those investors to intervene with management: if, in doing so, they acquire inside information, they are no longer legally able to trade.

As for the takeover threat, managers increasingly register their companies in the state of Delaware, which is notoriously manager-friendly. Many companies have put in place "poison pills" that make it hard or even impossible to take them over. As a result, there have been few successful hostile bids in the past few years. Worst of all has been the abuse of stock options. Company bosses have manipulated these to reward themselves for mediocre performance or worse, which has allowed them hugely to increase their remuneration (see chart 9). The cult of the chief executive, which has grown up alongside both the long bull market and the equity cult, has encouraged bosses to ignore many of the norms of accountability.



What are shareholders doing to fight back? Quite a lot, as it happens. Institutional shareholders, especially large ones such as Fidelity or TIAA-CREF (an educational pension fund that is now the biggest pension manager in America), are taking corporate governance more seriously. They are so big that they find it hard to sell their shares without depressing prices; anyway, many track broad share indices, so may not want to sell. Instead, they take trouble to exercise their votes, and are ready to tackle company bosses direct. Robert Pozen, the head of Fidelity, describes himself as a "reluctant interventionist"—but intervene he does, all the same. TIAA-CREF has campaigned long and hard against the abuse of stock options. CalPERS, the pension fund for Californian public employees, has made a career out of intervening to shake up poorly performing managers.

Life on the edge

Perhaps most significant has been the newly acquired habit of sacking the boss. Turnover of chief executives in America is at an all-time high. Boards of directors are more assertive than they were. Institutionalising job insecurity for companies' chief executives may yet prove the most effective of all systems of corporate governance. And, like the rest of the American system—indeed, like the equity culture itself—it is seeping into other countries.

More vigorous corporate governance is certainly needed outside America. Even in Britain, the country whose system most resembles the American one, shareholders do not always seem forceful enough in calling managers to account. For every activist fund manager who is careful to exercise all his votes, such as Alastair Ross Goobey of Hermes, there are a dozen inactive ones. Companies such as BT have managed to get away with strategic mis-steps and underperformance over a number of years without their managers being punished or sacked—although BT's managers have recently come under increasing pressure (ironically enough, Hermes started life as BT's pension fund).

But the system in other countries is less vigorous still. For many years, this was seen to be a virtue. Academics extolled the German-Japanese model (as against the Anglo-American one), in which companies relied largely on banks for finance and one or two shareholders (often also the banks) dominated. This was deemed to deliver splendidly "patient" capital, as opposed to the unhelpful "short-termist" Anglo-American variety. Two-tier boards in Germany, with a supervisory and an executive level, enforced accountability and allowed companies to take into account the interests of all their "stakeholders", not just their capital providers. In Japan, the *keiretsu* system of cross-shareholdings within a family of companies, centred on a "main bank", worked in a similar fashion. Both systems put

the shareholder much lower down the pecking order than did America and Britain.

One of the most striking features of the past decade is that most of the arguments in favour of the German or the Japanese models of corporate governance seem to have vanished. An obvious explanation is that, whereas in the 1980s the German and the Japanese economies seemed to be doing better than the American one, in the 1990s the balance of economic performance was reversed. But the model is itself quietly being dismantled. For as an equity culture has spread in Germany, France and even in Japan and Italy, these countries have been inexorably evolving in the American direction. Bank and cross-shareholdings have been unwound (in Germany, Allianz's recent takeover of Dresdner Bank was a big step in this direction). Institutional shareholders are now courted and individual shareholders encouraged. And companies now pay more attention to their share prices than they did.

It is true that there is still some way to go. Ask Ekkehard Wenger, an economics professor at Würzburg University and the best-known shareholder activist in Germany, about the arrival of new institutional shareholders, and he responds tartly: "You do not solve the agency problem by creating more agencies." He points to DaimlerChrysler, Germany's biggest company, whose boss, Jürgen Schrempp, remains at the helm despite the company's lamentable performance over the past three years. When Mr Wenger sought to question the company's strategy at one of its recent annual meetings, his microphone was switched off.

Minorities lose out

The abuse of minority shareholders remains endemic in many European countries. Some companies use the Netherlands' extraordinarily management-friendly corporate law to protect themselves from takeover. In 1999 Gucci, a luxury-goods firm, exploited the Dutch rules to avoid putting a takeover bid from LVMH, a bigger French rival, to its shareholders. Italian companies routinely ignore shareholders' interests, as Olivetti did last year when it sought to move the mobile-telephone assets of the newly acquired Telecom Italia into a vehicle that it controlled. In France, Vivendi, often seen as the pioneer of American-style corporate governance, got into trouble at about the same time, for unilaterally altering voting weights to suit its management. In Japan, some cross-shareholdings, so far from being unwound, are actually being increased—and most companies still hold their annual meetings on the same day in June.

Yet the broad thrust of change in the direction of the Anglo-American system is clear, even to Mr Wenger and fellow activists such as Switzerland's Martin Ebner. Two strong forces are behind it. The first is Europe's and Japan's desire to learn from the American economy's success over the past decade. Rightly or wrongly, a part of that success is now attributed to the superiority of the Anglo-American model of corporate governance. Europe's and Japan's patient capital may have virtues, but it also has the vice of not being quick enough, or tough enough to insist on better corporate performance.

Foreigners rule

The second force is even harder to resist: the growing influence of foreign shareholders and, particularly, of the American investing institutions. CalPERS, Fidelity and TIAA-CREF are typical of the new breed. As big European and Japanese companies eagerly list on the American stockmarkets, they have to comply with American rules on accounting standards, disclosure and transparency—and inevitably, they find, with the norms of American corporate governance too. But even when companies do not choose to list in New York, their shareholder register is increasingly dominated by foreigners. As much as half of the shares traded on the Paris bourse, for example, are now in foreign hands; in some other countries the proportions are similar.

When Britain's Vodafone, a mobile-phone operator, hit the headlines with its hostile bid for Germany's Mannesmann in December 1999, there were suggestions that the Mannesmann team might resort to various "barbed-wire" defences permissible under German corporate rules, or that the German government might intervene. In fact neither happened, and commentators applauded the Germans for their restraint. But in truth Mannesmann had little choice, because most of its shareholders were foreign already, and they wanted the takeover battle fought out on its own merits. It was one more sign of the triumph of Anglo-American capital markets and of the new equity culture. Yet it did not answer perhaps the biggest question of all: will that triumph be good or bad for the world's economies?

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When capital markets rule

May 3rd 2001
From The Economist print edition

The growth of equity will be good for economies

THE rivalry between different models of corporate governance partly reflects a broader battle over the best way of financing a modern economy. In this battle, the world's growing equity culture plays a crucial role, for it turns on one big question: is it better for economies if their companies rely mainly on capital markets for equity and debt, or on banks? It is a question that is pertinent not just to the debate about the respective merits of the Japanese/German model and the American/British one, but also to the choices that emerging economies should make about their future.

At first sight capital markets might seem a pretty dubious proposition to rely upon, especially in today's bearish climate. Capital markets are naturally short-termist and volatile. They attract huge inflows that can just as quickly turn into huge outflows. Investors' crowd behaviour can move prices out of line and lead to speculative bubbles. When such bubbles burst, the capital tap can be turned off just as quickly as it was turned on. Contrast the dotcom boom, when finance for even the most bizarre business proposition was to all intents and purposes free, with the bust, when even sound business plans could not attract capital at any price.

The consequence of all this is surely a damaging misallocation of capital that, so far from fostering growth, might actually discourage it. Even in America, in the early part of 2000 there were howls that the new economy and the Internet were gobbling up all the money available for investment, starving "old-economy" companies (which, unlike "new-economy" ones, actually made profits) of capital. Within months the position was reversed, and a lot of investors, many of them first-timers, had lost their shirts. No wonder that some countries (and some investors) mistrust capital markets, and especially stockmarkets; they seem so often to resemble Keynes's notorious casino.

Yet there are also substantial virtues in relying on capital markets. Because they react continuously and almost instantaneously, equity and debt markets immediately capture any changes in perception about the future course of economies, or about confidence, or about risk. This process of "marking-to-market" means that assets are quickly repriced to reflect new circumstances, including new ideas, new techniques and new technology, to all of which capital markets respond more quickly than banks. One example is the development of the junk-bond market in the late 1980s. Because they cut out a layer of intermediation, capital markets are also generally cheaper than banks.

Banks, on the other hand, have several virtues of their own. They are excellent instruments for gathering together small deposits into large pools of capital that can be made available for bigger borrowers. They can employ skilled loan officers to judge different credit risks, and they offer helpful advice to small entrepreneurs. Their intermediation miraculously transforms short-term, highly liquid cash (deposits) into long-term, largely illiquid assets (loans). They can redirect capital from low-return or poor-risk activities to high-return or lower-risk ones. And they can be more "long-termist" than markets.

And yet the downside to relying on banks can be huge. The tumble taken by most of the world's

stockmarkets this year may have grabbed the headlines, but to nothing like the extent that a big bank bust would have done. The 1930s depression was a consequence of America's bank meltdown (made worse by foolish monetary and trade policy), not of the 1929 stockmarket crash. Banks, it turns out, are even more influenced by popular delusions and the madness of crowds than markets, as repeated bubbles in many different countries have shown. Bank lending can be subject to political interference. But above all, banks do not mark all their assets to market. In bad times they find themselves sitting on assets for which there is no market.

This has a number of adverse consequences. It aggravates bad-lending sprees: because asset prices do not adjust speedily, price signals are jammed and loans continue to go into the wrong activities. Hence the building of so many pointless office blocks during the savings-and-loans crisis in America, or the massive bursts of overinvestment in Japan and South-East Asia. Worse, the failure to mark to market means that getting out of a bust can be slow and tortuous—as Japan has shown in the 1990s. Even today, the true price of Japanese banks' property collateral is unknown, because regulators do not allow it to be traded in the marketplace. The big difference between capital markets and banks, then, is not that one is prone to bubbles and crashes and the other is not; it is that capital markets bring home the pain immediately, making recovery quicker and easier.

Indeed, the Japanese and East Asian crises of the 1990s, rather like the depression of the 1930s, can best be understood as only the latest in a series of bank-created disasters. Governments everywhere have compounded the problem by devising schemes to underwrite deposits to protect depositors (who have presented banks with all those highly liquid liabilities) from such disasters. Because that exposes the exchequer to bank losses, governments then have to regulate banks more heavily, and depositors lack any incentive to monitor the health of their banks—a pernicious moral hazard.

Banks, in short, are what the late Professor Merton Miller once called a 19th-century technology that is also highly disaster-prone. Which is not to say, as some enthusiasts have suggested, that they can be got rid of altogether. The best-functioning economies are those that diversify their sources of finance, relying on markets when things go well but able to fall back on banks when risk appetites change. The classic recent example unfolded in the autumn of 1998, when debt and equity markets in America both seized up. President Clinton spoke of the worst crisis in 50 years; the Fed cut interest rates three times. But banks were able to step into the breach until markets recovered their nerve.

The evolution of finance

The evidence of the benefits of capital markets, and in particular stockmarkets, is not just theoretical. One study in 1998 of 47 countries found a strongly positive correlation between the size and liquidity of stock exchanges and economic growth. Similarly, investigations of development have found strong links between the growth of non-bank financial intermediaries and the growth of economies. For this reason, the IFC, the private-sector arm of the World Bank, is especially keen to promote stockmarkets in emerging economies.

Indeed, an evolution of finance seems to be at work. In the early stages of development, local banks (eg, country banks in Britain's industrial revolution) are needed to gather local savings together in order to provide enough capital for growth. Later, big clearing banks that can operate at national level start to emerge. At that early stage companies rely largely on internal financing and bank loans. Banks are useful mainly because capital is so scarce. The problem is not so much a matter of allocating plentiful capital to the best use as of finding enough capital in the first place.

In the next stage of growth, capital is relatively more abundant, so markets are better placed to take over the task of capital allocation from banks. The initial capital markets, for bonds and equities, are soon complemented by others, such as commercial-paper markets. Once these are in place, the scene is set for the arrival of ever more sophisticated instruments for slicing and dicing credit risk to suit different investors. Convertibles, derivatives, high-yield bonds and the rest join the panoply, blurring the distinction between debt and equity. After all, most debt has what might be called an equity element embedded in it.

Consider the story of venture capital in Silicon Valley in the late 1990s. As the Internet revolution spread, the preferred mode of finance for its pioneers became venture capital, usually committed by risk-taking funds that had gathered together savings from rich individuals and institutions. Traditionally, venture capitalists have had to wait for many years, until their companies could point to a solid record of achievement and profit, before they could cash out. However, the Netscape IPO of August 1995 changed

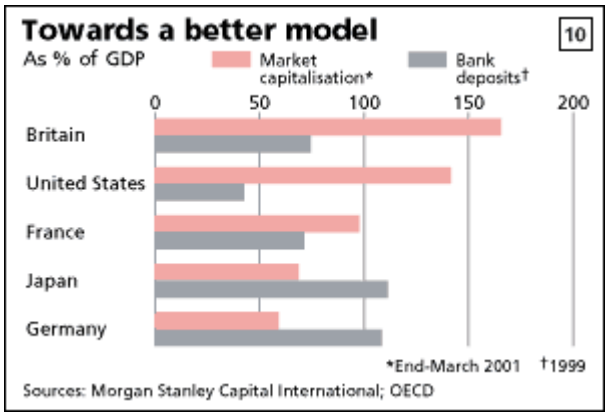
all that: the public equity markets seemed willing to invest in risky businesses that had never made profits and might never do so. The consequence was an explosion of venture capital, a rash of new Internet businesses, the dotcom mania—and the speculative bubble that gripped the Nasdaq stockmarket up to March 2000, after which the market crashed and venture capital dried up again.

What are the lessons from all this? Some maintain that the whole episode was a disaster, in which capital was thrown away on lousy business propositions, reputable investment banks ripped off gullible investors by sponsoring dubious IPOs supported by questionable research analysts—and lots of individuals got burnt. There is some truth in this picture, but it is nevertheless the wrong lesson to draw. The real significance was that, in a period of less than five years, capital markets were able to finance cheaply an entirely new industry; and when parts of the industry turned sour, promptly to reallocate the capital elsewhere.

The contrast is not just with the Japanese and East Asian experience of bank-financed overinvestment; in America, it is with the Texan oil bust of the mid-1980s and the New England property bust of the early 1990s. The pain from these was more widespread and longer-lasting than today's pain in Silicon Valley. And excessive as the TMT/Nasdaq bubble may have become, it has helped to finance a whole infrastructure that has boosted the American economy—and it has done it faster than a bank-led economy might have managed.

Equity culture vultures

America's greater reliance on capital markets than on banks is, according to the widely experienced Baron Lamfalussy, one of the reasons why, despite the excesses of its bubble, its economy has outperformed Europe's and Japan's over the past decade. Chart 10 illustrates the difference. Now the arrival of better-developed capital markets, and a stronger equity culture, first in Europe but increasingly elsewhere as well, should help the rest of the world to catch up. Banks will, of course, have to change a lot in a market-led system. Investment banking will become more important than normal commercial lending. Deposit-taking will shrink in relative terms; asset management will grow. These trends can already be seen at work, in the rash of recent mergers to create financial-services giants. More mergers are likely.



The question remains: could nascent equity cultures be marred by the markets' current troubles? In the short term, the answer is clearly yes. Even in America, the vogue for equities is fading, after so many investors have been punished so heavily over the past year. Earlier this year, the equity mutual-fund industry saw outflows for the first month in over a decade. Investors in other rich countries are also showing signs of aversion to shares. As for the developing world, equity markets have recently been something of a disappointment. The share of emerging economies in global stockmarket capitalisation has fallen from about 11% in 1996 to 6.5% today, far below their near-40% share of world output.

And yet most of this constitutes a blip, rather than a reversal, in a long-term trend. Even after the setbacks of the past year, global stockmarket capitalisation has tripled since 1990. Equity has grown in value faster than debt, and a lot faster than bank deposits. Most countries are seeing a slow but steady increase in the number of shareholders.

This change is unambiguously positive. A bigger role for capital markets should mean fewer and less persistent economic crises. The spread of share ownership will help to secure better pensions for today's baby-boomers. Above all, equitisation will underpin the system of market capitalism itself, by giving

more people a bigger and more direct stake in the success of their companies. It is a far cry from the scene in Ivan Goncharov's 19th-century Russian novel "Oblomov", when the crook Tarantsyev explains the concept of shares to a colleague in crime:

> It's a German invention!...Some swindler undertakes to build a town of fireproof houses, for instance. He needs money, of course, so he starts selling papers at 500 roubles each and a crowd of blockheads buy them and sell them to each other. If the business is reported to be doing well, the bits of paper rise in price; if it's doing badly, the whole thing goes bust. All you've got left is worthless bits of paper. Where is the town? you ask. Oh, they say, it's burnt down, or there wasn't enough capital to finish building it—and the inventor has meanwhile run off with your money. That's what shares are!

In countries with primitive financial systems—not least Russia—such things still happen. But these days shares are more familiar, the regulation and operation of stockmarkets are better, and even corporate-governance systems are improving. The new century is set fair to be the age of the equity.

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Sources

May 3rd 2001
From The Economist print edition

This survey has drawn on many published sources and interviews. Among the books used are "Stocks For The Long Run" by Jeremy Siegel (McGraw Hill, second edition, $29.95); "Irrational Exuberance" by Robert Shiller (Princeton University Press, $27.95); "Valuing Wall Street" by Andrew Smithers and Stephen Wright (McGraw Hill, $29.95); "A Random Walk Down Wall Street" by Burton Malkiel (Norton, seventh edition, $16.95 paper); and "What Is An Exchange?" by Ruben Lee (Oxford University Press, $35.00). Several articles in the *Journal of Applied Corporate Finance* were also useful, especially "Financial Markets and Economic Growth" by Merton Miller, in the Fall 1998 issue. The author is grateful to all those who helped with the survey's preparation.

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May 3rd 2001
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Pass the painkillers

May 3rd 2001
From The Economist print edition

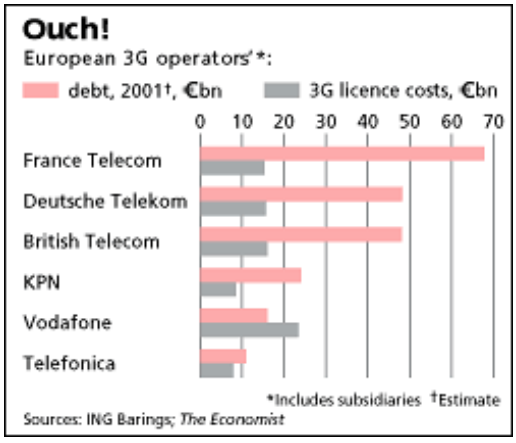
The introduction of "third-generation" mobile phones is being plagued by fearsome technical and financial difficulties

Get article background

DO MOBILE phones cause headaches? In the case of third-generation (3G) telephones, the answer is undoubtedly yes—even though nobody is yet using them. Instead, they are causing technical and financial pain for all the companies around the world that are trying to build 3G networks.

The idea behind 3G was to offer subscribers exciting new features, such as video clips and high-speed Internet access, for which they would be prepared to pay far more than they now do for boring old voice calls and text messages on 2G phones. Operators have spent vast sums—around $125 billion in Europe alone—buying licences to enable them to offer such services (see chart), and have run up huge debts in the process. Building the networks will cost about the same again. It is a huge gamble—and one that is looking riskier by the minute.

The technical problems that have delayed the availability of 3G handsets and base-stations are unwelcome, but they are not insuperable. Nor are they terribly surprising. Previous technologies such as GSM, WAP and GPRS were all late as well. One problem is power consumption, since 3G phones are more demanding than existing models. Another is that 3G handsets contain more software—they are, in effect, pocket computers. NTT DoCoMo, the wireless arm of NTT, which was supposed to launch the world's first 3G service in Japan this month, has blamed software glitches for its decision to delay the launch until October.



Even when the power consumption and software have been sorted out, 3G technology will have to be combined with existing telephones to produce handsets that work as 3G phones when they are near a 3G base-station, but revert to 2G the rest of the time. Such hybrid handsets are vital, because it will take many years for the network operators to provide blanket 3G coverage. But hybrids are even harder to make than 3G-only handsets, and they will not be available in any quantity until next year at the earliest. "The handsets are always late," says Henry Elkington, an analyst at Boston Consulting Group. "It's the golden rule of mobile telecoms." Instead of launching next year, as planned, most 3G operators are now talking about 2003.

This delay has serious financial repercussions. Given the expense of the 3G licences and infrastructure, the operators want to launch their services and start generating revenue as quickly as possible. But the uncertainty has hit their share prices; and the debt burden has led to cuts in their credit ratings that have made it harder for them to raise money. Britain's BT, for instance, was forced to sell prized

Japanese and Spanish assets to Vodafone this week, to reduce the massive debts it incurred when buying 3G licences. BT, whose long-serving chairman, Sir Iain Vallance, stood down last week, now plans a huge rights issue that may further upset its long-suffering shareholders.

Worse even than these cash travails, the initial projections of how much operators could expect to charge for 3G services now look highly optimistic. It has become clear that 3G will take far longer than expected to become profitable, so operators will sink deeper into debt along the way. Things are particularly tough for new entrants, such as Group 3G in Germany and Hutchison 3G in Britain, that do not have 2G networks and so must start from scratch.

The industry is pursuing a number of ways to make 3G less painful. One approach is “vendor financing”, in which equipment makers, such as Nokia, Ericsson and Alcatel, lend money to network operators that buy their equipment. According to Louisa Greenacre, an analyst at ING Barings, some vendors are now lending as much as 200% of the cost of hardware purchased, thus providing operators with working capital that they are unable to raise from banks and public markets. This means that the equipment vendors are taking on risk, particularly when lending to new entrants that do not have any revenues at the moment. And debt is still debt, whoever is lending the money.

Some new entrants are compensating for the delayed launch of 3G by becoming “virtual operators”, or resellers, for other firms’ existing 2G networks. The advantages of this strategy are that it provides short-term revenue and allows new entrants to phase in their 3G infrastructure over time by giving their subscribers hybrid handsets. The logical conclusion of this is “network-sharing” in which two or more operators agree to share some of their 3G infrastructure, so as to roll out their 3G networks more quickly.

There are, however, a number of problems with network-sharing. It would be technically tricky to handle roaming from non-shared to shared parts of the network; operators would, in practice, find it easier to share their entire networks. Network-sharing is also banned under many countries’ licensing terms, on the grounds that it is anti-competitive. The whole idea of selling several 3G licences to different operators was, after all, that it would encourage the construction of several competing networks.

But some operators, particularly new entrants, are keen on network-sharing and are pressing regulators to relax the terms of their licences to allow it. The pressure is particularly strong in Germany, which has issued licences to six 3G operators, including two new entrants. Despite reservations expressed by Mario Monti, the European Union’s competition commissioner, the German telecoms regulator, RegTP, has indicated that it is sympathetic towards some network-sharing.

Regulators are also being pressed to relax other aspects of the licence terms. In Germany, for example, operators are required to provide 3G coverage for 25% of the population by the end of 2003, and for 50% by the end of 2005; in Britain, operators do not have to meet any coverage targets until 2007, by which time 3G services must be available to 80% of the population. Now that the launch of 3G has been delayed, say the operators, these conditions look unreasonable. In Spain, where the licence terms committed operators to launching their services in August of this year, the terms have been modified to allow a delay until June 2002.

Many operators are hoping for concessions in other areas, too. There is a widespread feeling that European governments, having pocketed billions in licence fees before the steep fall in share prices last year, should now come to the aid of the operators. The British government was recently rumoured to be considering a partial refund of licence fees, though this was swiftly denied by a minister. Another concession, which would suit the German operators in particular, would be to allow one 3G operator to take over another without having to hand back its licence, and to allow the resale of licences. But although some consolidation clearly makes sense in the overcrowded German market, reducing the number of operators would also raise competition concerns.

Amid all this uncertainty, it is clear that it will be several painful years, rather than months, before 3G becomes widely available. Even if the operators can meet their debt burdens and build the networks, it is not at all certain that they will be able to make much money from them. Today’s headaches might then seem mild compared with those that are to come.

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Japanese trading houses

Reinvented

May 3rd 2001 | TOKYO
From The Economist print edition

"PEOPLE used to tell Japanese travellers, if they got into trouble overseas and couldn't find a consulate, to look for a trading house instead. There was bound to be one nearby," jokes Motoyuki Oka, managing director of Sumitomo Corporation. With their networks of offices, stretching from Vladivostok in Russia to Quito in Ecuador, Japan's trading houses were everywhere. In 1990 they controlled, by value, three-quarters of Japan's imports and almost half its exports. At home, the biggest houses—Mitsubishi Corporation, Mitsui & Co and Sumitomo—sat at the centre of the powerful *keiretsu*, or corporate families, that dominated many industries. As middlemen, they bought and sold raw materials, channelled information, financed the construction of new factories and traded finished goods.

In the 1990s, however, their traditional trading business started to decline. As global competition intensified and the domestic economy weakened, manufacturers began to cut costs by weeding out inefficient intermediaries—a process speeded up by the Internet. It seemed that the trading houses were inexorably fading away.

Not so, says Toby Williams of UBS Warburg. Trading houses largely abandoned their role as simple traders long ago. They now perform sophisticated outsourcing functions instead. Demand for their supply-chain management services is particularly high. Mitsubishi, for instance, helps Uniqlo, one of Japan's most successful retailers, to manage its relationships with suppliers. Itochu handles logistics for such foreign firms as Starbucks and Nestlé.

These days, trading houses are moving their services online. Mitsubishi plans to set up eMaterialAuction, an online marketplace for steel sheets, next month. Mitsubishi wants to take orders from companies that are too small to deal directly with the likes of Nippon Steel, Japan's biggest steel maker. It will take on inventory risk and act as a troubleshooter for small firms. It will also provide 90-day credit for customers and has, with Orix, a leasing company, set up eMerchantBank to help do this. The format, says Naoto Mizoguchi, Mitsubishi's head of strategic planning, could eventually be applied to industries such as textiles and chemicals.

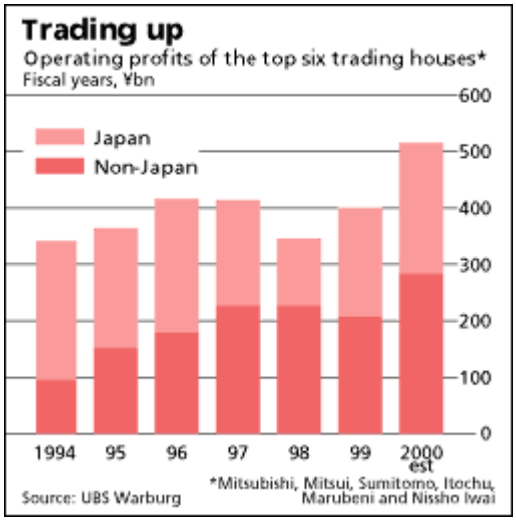
Since these are hardly growth industries, trading houses are also sniffing around for businesses that offer bigger profits, such as information technology and biotechnology. Some have been extremely successful. According to Kenichiro Yoshida of Nikko Salomon Smith Barney, Itochu has already earned ¥284 billion ($2.4 billion) by selling some of its shares in a subsidiary, Itochu Techno-Science, a systems vendor that listed its shares two years ago. Mitsubishi also made lots of money when it sold its stake in Photonic Integration Research, an American optical-components maker, last year. Several trading houses are expected to announce record profits when they unveil their annual results for 2000-01 later this month.

Overseas markets have also offered an attractive alternative to sagging domestic ones. Non-Japanese operating profits at the top six houses have grown, on average, by around 20% a year for the past six years (see chart), and now account for roughly half of their total operating profits. Many, such as Itochu, whose American subsidiaries hold leading positions in specialist markets such as nails and metal fences, want to do more abroad. "These niches are highly profitable for us," says Yoichi Okuda, chief executive of Itochu International.

Despite these successes, trading houses still need to clean up lots of dud investments, mainly in property, left over from the bubble years of the 1980s. They also need to drop their unprofitable operations. The top nine trading houses have, on average, around 600 subsidiaries or affiliates apiece. Almost a third are unprofitable because "trading houses have had a bad habit of jumping into businesses that only look like they're making money," admits Morihiko Tashiro, president of Tomen, a medium-sized trading house, which has a 30% share of Japan's fast-growing wind-power industry.

Trading houses are also trying to improve their efficiency by consolidating operations. The biggest mergers, which are taking place among their steel divisions, will give the houses greater bargaining power with suppliers and customers. Mitsubishi and Nissho Iwai, for example, will merge their steel operations in October, to create a company with annual sales of over ¥2.2 trillion.

There are tougher challenges ahead. The big trading houses have a lot of work to do before they can show that their latest fad—buying large stakes in retailers—is a winner. Meanwhile, their share prices have suffered as the unwinding of cross-shareholdings among *keiretsu* companies has gathered pace. Companies such as Itochu, Nissho Iwai and Tomen are struggling to raise their credit ratings, which are below investment grade. But at least the trading houses have shown that they are far from dead. If they can continue to reinvent themselves, they might provide even bigger surprises in the future.



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The music industry

Gone again

May 3rd 2001
From The Economist print edition

ERIC NICOLI can hardly be accused of pessimism. “We are excited about EMI’s future,” said the music company’s chairman, as he announced the collapse of yet another set of merger talks between his company and a rival on May 1st. The news that EMI had called off its discussions with Bertelsmann, a German media group, about combining their respective music businesses, came just six months after Mr Nicoli had announced the failure of a previous planned fusion, with the music arm of AOL Time Warner, an American media giant. If, as Mr Nicoli argued this week, EMI can now look forward to a dazzling future without a merger, then why has the firm spent nearly 18 months trying so hard to secure one? As one EMI insider concedes: “It looks absolutely awful.”

The main reason to worry about EMI’s prospects as a solo business is that the world’s music market, worth $37 billion, has been stubbornly flat. Since peaking in 1996, after even die-hard vinyl-junkies at last got round to duplicating their record collections with compact discs, global music sales have stalled. The real value of sales of recorded music actually fell between 1997 and 2000, as did the number of recordings sold.

Already, the big five record companies between them control over three-quarters of the world music market, and that figure has remained steady. So a tie-up within the industry has seemed to be the only logical way to grow. EMI was also hoping to reap cost savings from its planned merger with BMG, Bertelsmann’s music arm, worth at least £200m ($287m). The project, however, was called off after indications from EU competition officials that it would be subject to a lengthy inquiry, with no guarantee of success and onerous disposal requirements. None of the big five is now likely to try a similar merger for some time.

Another option for EMI might be to join one of the global media giants, such as Disney, News Corp or Viacom. The argument would be that these groups, whose tentacles reach from satellite broadcasting and the Internet to theme parks and shops, have many more ways of pumping out music to record buyers and turning bands into brands, with dolls, games and the like.

Would going it alone be such a bad thing for EMI? It is the only one of the big five that remains independent of a media conglomerate, and, with a market capitalisation of just £3.5 billion, it is a minnow compared with AOL Time Warner or Vivendi Universal. But in the long run, argue the enthusiasts, the online downloading of digital music, which the big record labels have until recently regarded as a menace rather than a means of salvation, could breathe new life into music sales. The easy ability to sample new tracks online, goes the argument, may tempt people to buy lots of stuff that they would not otherwise hear about.

Each of the big record companies has now signed up to one of two plans to set up a secure way of selling music online. EMI has joined with Bertelsmann and AOL Time Warner to create MusicNet; Sony and Vivendi Universal have formed Duet. But, for now, these plans are on paper only. Despite successful efforts by the record companies to police the copying of tracks by some of their bestselling artists, online file-swapping still goes on. It will be some time before the dream of a global jukebox of the sort that might begin to reinject growth into music sales becomes a reality.

In the meantime, EMI is back where it started. And that is a place Mr Nicoli insists he is quite happy to be. EMI “is not a piddling business that somehow needs a home,” he snorts. The group this week announced that unaudited pre-tax profits for the year to March 2001 grew by 6% from the previous year, to £260m. In the first quarter of this year, EMI’s market share in America, its weakest point, shot up to 11.3%, from 7.3% in the same quarter of 2000—although quarterly figures in an industry where one or two mega-hits can hugely inflate revenues may be suspect. EMI’s sales boom in America so far this year has owed a lot to the release of The Beatles’ “1”, yet another compilation of old songs.

There are only so many times that EMI can repackage old bands. In the end, the record business is about

spotting, nurturing and manufacturing stars. Only some 5-10% of all signed artists make any profit for their labels. EMI does have talent on its books that is big in America: it recently signed Mariah Carey, for instance. And it has had some success in promoting British bands there, from the Spice Girls to Radiohead and, more recently, Coldplay. What EMI needs now is exactly what it needed before its latest merger fiasco: to lure good people to run its labels in America in order to attract more stars—precisely the sort of thing that is so hard to do when the future is uncertain.

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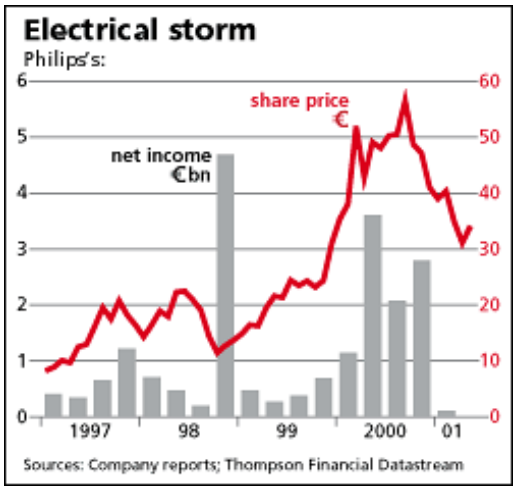
Philips's new frontiersman

May 3rd 2001
From The Economist print edition

Gerard Kleisterlee, the new boss of Royal Philips Electronics, wants to restore the Dutch group's pioneering spirit. He faces challenges on several fronts

HOW quickly fortunes can change. In early February, Philips, a giant electronics, lighting and high-technology group based in the Netherlands, announced that 2000 had been a record year. Sales had risen by one-fifth to *euro*37.9 billion ($34.8 billion), and the return on net assets was an impressive 24%. Cor Boonstra, the outgoing chief executive, crowed that Philips had regained the financial health that it had lacked when he became boss in 1996, two years after joining Philips from Sara Lee, an American food group. Gerard Kleisterlee, his nominated successor, who took over on May 1st, was widely praised for his deft handling of the troubled components business. In a fit of optimism, the management board raised the group's financial targets. Henceforth, it said, annual revenues and earnings per share should rise by 10% and 15% respectively, and overall return on assets should hit 30%.

That now seems remarkably naive. Within weeks it was obvious that, in the opening months of this year, several of Philips's main markets had slowed down abruptly; falling demand for semiconductors and telecoms equipment clobbered the bottom line. By mid-April, the company was announcing ghastly first-quarter results (see chart) and warning that it will dip into the red in the second quarter, its first three-month loss since 1996. Cashflow, strongly positive last year, has turned negative. Worse, up to 7,000 jobs are to be cut, if shocked trade unions agree.



It is an inauspicious beginning for Mr Kleisterlee, made more painful because the components division that propelled him into the top job has been especially ravaged by the downturn. In succeeding Mr Boonstra, he became only the 11th boss of Philips since it was founded in 1891. He has a tough act to follow. Mr Boonstra took bold steps to shake up a group that was muddled and loss-making. Underperforming and peripheral businesses, including such well-known names as Polygram and Grundig, were sold. Money was channelled towards the semiconductor and medical-equipment arms, which had better growth prospects. Philips's profits improved and it won back investors' confidence.

Mr Kleisterlee, an articulate Dutchman who trained as an engineer and has worked for Philips all his professional life, now has to limit the same investors' inevitable sense of disappointment. His job will not be made any easier by those financial targets, although he might balk at repudiating them too fast. He has, however, already shown that he has his own ideas about what Philips needs.

Even before taking over, he was distancing himself from the Boonstra years. These he characterises as promoting a culture of "every business for itself". This worked fine when the goal was to streamline the portfolio and restore financial health. Now he wants a more co-operative approach, with divisions working together to innovate. Asked about outsourcing, he says he has an open mind, particularly over alliances. "But we have almost everything we need in-house," he adds.

Mr Kleisterlee would like a more focused Philips, dominated by high-tech products and displaying the same pioneering spirit in the Internet age that made it an early leader in the electrical age a century ago. In fact, Philips is already quite tech-minded. Last year, almost three-quarters of its profits came from high-growth technology. Rediscovering the pioneering spirit will be the hard bit.

No doubt Mr Kleisterlee intends to move away from what remains of Philips's conglomerate culture. But he might find that such longer-term cultural changes will prove insufficient to address the group's current

challenges. Consider semiconductors. These have become the biggest single contributor to Philips's earnings. Mr Boonstra faced pressure last year to launch the business as a separately quoted entity, but chose, perhaps unwisely, not to do so. Analysts expect that its revenues will fall by some 15% this year. Until the cycle picks up again, this division, and so Philips as a whole, is likely to struggle. There is little that even the cleverest managers and the warmest co-operation can do about that.

The consumer-electronics businesses are no less of a challenge. Mr Kleisterlee would earn a cheer from investors if he decided to tackle Philips's loss-making mobile-phone arm. Some analysts fret that he lacks the will. Yet, although he looks like the ultimate company man, he clearly has a non-conformist streak. Last year, for example, he shifted the headquarters of the components business from Eindhoven, the historic group base in the Netherlands, to more entrepreneurial California. The equivalent leap for the mobile business would be closure.

Other bits of Philips are struggling to be consistently profitable enough to be worth keeping as stand-alone operations. Competition in mainstream consumer goods, such as televisions and DVD players, is ruthless. Philips has plenty of fancy technology—in wide-screen TV, for example—but its brand is weaker than those of some Asian rivals, notably Matsushita (Panasonic) and Sony. In future, says Mr Kleisterlee, products and services will have to get to market much faster, to ensure that Philips catches their fastest-growing phase. The implication is that chronically slow-growing businesses will be jettisoned.

Every new boss deserves a little leeway, if only so that he can impose his ideas and see if they work. Thanks to market conditions, though, Mr Kleisterlee might find, as many other managers have done recently, that a well-argued strategic vision becomes a secondary concern when there are pressing operational problems to solve. In his first few months, he will need determination to pare, sell and shut down bits of his empire, quite possibly in the face of fierce internal opposition. Taking Philips to a new frontier is Mr Kleisterlee's toughest challenge to date. But no true pioneer ever found life easy.

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Boeing and Airbus

A phoney war

May 3rd 2001
From The Economist print edition

Boeing may have shied away from a fight with Airbus's super-jumbo. But in marketing its "sonic cruiser", it is learning from the Europeans

LATE last year Alan Mulally, boss of Boeing Commercial Airplane Group, thought he was about to land some crucial orders for the stretched 747 that he wanted to launch to compete with Airbus's super-jumbo, the A380. As Airbus, based in Toulouse, raced towards the 50 orders it needed to launch its giant, Mr Mulally was pinning his hopes on a deal with Federal Express to buy freighter versions for its huge cargo airline. When he learned that Fedex was going to buy the all-new Airbus, it was time to face facts.

Nobody wanted the latest stretched 747, just as nobody had wanted an attempt to upgrade the ageing war-horse a few years earlier. A 32-year monopoly as the queen of the skies was coming to an end. For the Seattle company, which had already seen Airbus's share of the civil-jet market rise from a fifth to half, losing roughly 50 to nil on the orders score was too much to bear. Boeing wisely decided to withdraw from the contest, while it thought up a different one.

That is the real story behind the fanfare at the end of March, when Boeing announced that it was switching its attention from a super-jumbo to an entirely new aircraft: a long-range jetliner, dubbed the "sonic cruiser" because it would fly at just below the speed of sound, cutting an hour off transatlantic flights and saving three hours over the Pacific. This may well be what the market wants: even Airbus agrees it might have potential. "We also have design studies for aircraft like that," says Rainer Hertrich, co-chief executive of Airbus's parent company, EADS. "If the market likes it, we'll see how we react." That is probably bombast, as Airbus would struggle to launch a second all-new aircraft, if Boeing is in the lead, just as Boeing would struggle to make money against the Airbus super-jumbo, a huge punt made possible only by soft government loans.

Boeing is still far from committed to launching its faster aircraft, however: it is merely talking it up to attract interest among the travelling public and airlines. This is exactly what Airbus did for several years before winning enough orders to launch the A380. All the guff about the A380's on-board gyms, casinos and saunas bears little relation to airline reality. Most launch customers are determined to pack in as many seats as possible, to maximise revenues. All the same, Airbus has taught Boeing that hype is now a key part of launching aircraft.

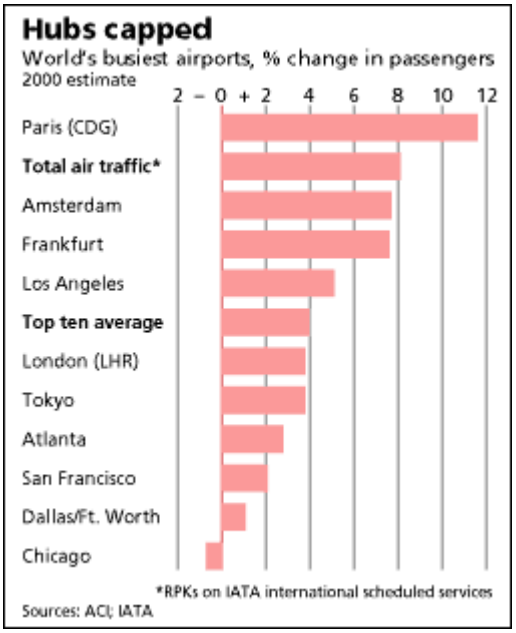
In the early 1990s, Boeing and Airbus considered a joint venture to build super-jumbos. But their talks came to nothing, and Airbus executives suspected that it was all a ploy by Boeing to delay Airbus's own super-jumbo. The two sides emerged from their brief liaison with starkly different views of the potential demand. Boeing estimated that, over 20 years, there was a market for only about 700 aircraft of the size of the 747 or bigger. Airbus, on the other hand, reckoned there was demand for 1,550 aircraft, worth $345 billion. After many false starts, Airbus eventually began marketing its aircraft a year ago. By last autumn, it had landed some big orders, notably from Singapore Airlines. In December, Airbus launched the programme, which now has 62 orders and 40 options from eight carriers. The first A380, destined for Singapore, should fly in late 2006. Until then, Airbus is likely to face a dearth of new orders, while airlines weigh up whether they have to follow the early customers, but without the steep discounts those first-movers enjoyed.

When it was trying to persuade airlines not to buy the Airbus super-jumbo, Boeing argued that the airline market is fragmenting, with more growth coming from direct flights between cities large and small, rather than from flights between big hub airports. There is evidence to support this: traffic growth at most hubs (with some exceptions, such as Paris Charles de Gaulle) is much slower than overall growth of 8% a year worldwide (see chart). Analysts such as John Lindquist of Boston Consulting Group, are convinced that Boeing is right about fragmentation, which is making it easier to open new routes as aviation markets liberalise.

Boeing's new view is that more and more business passengers

(who contribute most to airline profits) will opt for a fast, long-range aircraft that flies direct to their final destination, saving them a change at a hub. Boeing expects the Pacific market to fragment, rather as the Atlantic routes have done over the past 20 years. Airbus accepts much of this argument, which is why it launched its A340 long-haul aircraft to compete against Boeing's 777. But Airbus still believes that the sheer growth of traffic between a dozen or so global hubs, at which landing slots are limited, will force airlines to choose the A380 over the 747.

Moreover, Boeing's sonic cruiser has a big hurdle to clear: fuel efficiency. Although many American airlines reacted enthusiastically to the planned Boeing jetliner, they will need to be convinced that it can fly at just under the speed of sound without consuming too much fuel. Today's jets fly more slowly than their predecessors did before the 1973 OPEC oil-price rise, to save fuel. Boeing is confident it can keep the fuel consumption within affordable limits, given the premium that passengers will pay for speed.



Separate niches

If Boeing gets enough support to proceed with the sonic cruiser, it will have a niche product cornering the fast end of the market, while Airbus has another at the bulk end with the A380. And, as Oz Shy, an Israeli academic and author of a new book on network economics points out, both niches are appropriate markets to be occupied by only a single company. Both manufacturers have realised this. When Airbus moved to stake out the super-jumbo niche, the old Boeing would have plodded on with its rival stretched 747. But the new, profit-minded Boeing is happy to let Airbus take a chance, while it seeks another niche.

In any case, the real action may be elsewhere. Despite some glee in Seattle about having found an "Airbus killer" in the proposed sonic cruiser, this is a sideshow. The fiercest competition will continue to be between the two companies' single-aisle aircraft and the wide-bodied 250-380 seaters such as the Boeing 767 and 777 and the A330 and A340, where the two companies share the market roughly equally.

The duopoly's battle could extend beyond aircraft into aviation services. Boeing appeared to steal a march on Airbus last year when it launched "Connexion by Boeing" to provide broadband communications that would deliver fast Internet access and live TV pictures in aircraft. Continental Airlines is said to be interested in America, and Ireland's Ryanair wants live TV on every seat-back video screen, paid for by the passenger swiping a credit card.

Yet Boeing's "Connexion" has still to land a single customer, while a simpler narrower-band service from a small Seattle company called Tenzing is already being installed by Virgin Atlantic, Cathay Pacific and Singapore Airlines. The Tenzing approach has been to start modestly, then upgrade to real broadband once enough satellites are in place to make that work. According to industry sources, quoted by *Flight International*, an industry magazine, Airbus is negotiating to buy a big stake in Tenzing and plans to unveil its own Internet strategy at the Paris Air Show in mid-June. *Vive la concurrence,* even if it does not apply to super-jumbos and sonic cruisers.

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American retailing

On target

May 3rd 2001 | LONG ISLAND AND MINNEAPOLIS
From The Economist print edition

LAUREN BACALL and Robert Redford have both promoted it. And Oprah Winfrey thinks it so chic she pronounces the name in mock-French, with a soft “g”. Yet this is no luxury-goods brand, but Target, an American discount retailer that piles it high and sells it cheap, alongside such firms as Wal-Mart, Sears and Kmart. In a market segment in which customers care more about the price tag than the name over the door, Target is transforming itself from a mass-market chain into a bona fide brand.

This notion of the store as a brand is the brainchild of Bob Ulrich, chief executive of Target Corp, the chain’s parent. He compares Target to such names as Apple, BMW and, above all, Walt Disney, arguing that shoppers—whom he calls “guests”—should experience the same kind of consistency on their trips to stores as somebody visiting a Disney theme park does. And what does this experience amount to? According to Gerald Storch, Target’s vice-chairman, it is department-store-quality merchandise at discount prices, with lots of designer flair thrown in.

As a former McKinsey consultant, Mr Storch naturally has a bit of business theory to back this up. “We had three strategic choices,” he explains. “To specialise, to become the low-cost producer or to differentiate ourselves.” With the first of these offering little beyond a niche existence, and with Wal-Mart occupying the second, Target chose differentiation—by repositioning itself as a branded designer chain, but priced for the masses. To build a brand, Target has aimed for consistency. Unlike Wal-Mart, which tailors its stores to local shoppers, Target stores have the same look nationwide and sell more or less the same things.

What this means in practice becomes clear at Target’s one-year-old, 120,000 square-foot store in Valley Stream, Long Island. While the Kmart shop in the same mall is dingy, with narrow aisles cluttered with cardboard boxes and broken clothes racks, the Target store is spacious, brightly lit and clean. As in every Target shop nationwide, the main aisles are 12 feet wide and clear of boxes. John Iacobellis, the store manager, claims that sales at the Kmart nearby have fallen by a quarter since Target opened.

Consistency on the ground has translated into an impressive financial performance. Target Corp’s revenues have grown at a compound rate of nearly 10% annually over the past five years, and its earnings per share by more than 30%. The Target stores division, now four-fifths of the company, has continued to outperform Target Corp’s old-style department stores, which include Dayton’s, Hudson’s and Mervyn’s California. According to HOLT Value Associates, a consultancy, Target has improved its “cashflow return on investment” (a measure of returns that strips out depreciation) more than any other American retailer since 1995.

But in terms of overall returns, as well as sheer size, Target still lags Wal-Mart, retailing’s gold standard. With $190 billion in sales and 3,100 domestic stores, Wal-Mart dwarfs Target’s 990-store chain. The two companies’ net margins may be comparable and their cost structures similarly lean, but Wal-Mart is well ahead in productivity: its sales per square foot are $367, against $269 at Target, according to J.P. Morgan Chase.

Target is determined to narrow the gap through that sincerest form of flattery, imitation. It is “the world’s premier student of Wal-Mart”, says Mr Storch. One leaf it has taken out of its larger rival’s book is relentless expansion: despite the economic downturn, Target is increasing its capital spending by 40% to $3.5 billion this year to finance a 10-12% annual expansion in its selling space. Most of the new stores will be “SuperTargets”, selling a broader range of food than normal stores—a formula that has worked well in Wal-Mart’s “Supercenters”.

By contrast, Mr Storch is dismissive of Kmart’s latest turnaround under its new boss, Charles Conaway, who is reviving the retailer’s Blue Light special offers to lure back shoppers. “It’s a two-horse race—us against Wal-Mart,” insists Mr Storch. That may be so. But Target, stylish as it is, still has a long way to go to catch up with Wal-Mart.

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EM.TV's EMP.TY coffers

May 3rd 2001 | FRANKFURT
From The Economist print edition

"I HOPE soon, with all modesty, to be able to say: we're back there again." Back where, exactly? To square one. This week, Thomas Haffa announced that EM.TV, his Munich media company, had lost a gigantic DM2.8 billion ($1.6 billion) in 2000, more than twice its revenues. This largely reflected, he said, a "ruthless clean-up" of its figures.

Reuters

Haffa prefers bulls

A year ago, Mr Haffa's face beamed out of countless glossy business magazines, as EM.TV made a string of spectacular acquisitions, buying the Jim Henson Company, maker of the Muppets, and also half of SLEC, which controls Formula One motor racing. Now these have become equally spectacular write-offs. The value of the SLEC stake has been slashed by DM1.3 billion, and that of the Jim Henson Company by DM684m. In effect, EM.TV has admitted paying enormously over the odds—and all this with not a dotcom in sight.

Mr Haffa hopes the write-offs will be the last of a series of catastrophes, including mistakes in last year's second-quarter accounts and a profit warning in December that cut forecast earnings by 90%. The share price is now less than 5% of its peak in February 2000. EM.TV has survived only by virtue of a rescue deal with Kirch, a privately owned media group where Mr Haffa once worked. Kirch plans to buy 17% of EM.TV and 25% of the voting rights; EM.TV will get Junior, a library of children's television programmes that was formerly a joint venture between the two companies. A Kirch executive has joined EM.TV's board.

Now EM.TV's interests are shrinking as quickly as they swelled. The company will concentrate once again on children's programmes, in the shape of Junior. This is not certain to be trouble-free. Junior lost money last year; and December's profit warning stemmed from a realisation that programme sales had fallen short. EM.TV wants to sell the Jim Henson Company, or to find a "strategic partner". The Kirch rescue will oblige EM.TV to sell its 45% stake in Tele-München, another media group, to satisfy antitrust officials.

Kirch's involvement has also reduced EM.TV's interest in Formula One. As part of its bail-out, Kirch bought half of EM.TV's share in SLEC. It also put up $1.1 billion to pay for a further 25% stake that EM.TV had an option to buy from Formula One's founder, Bernie Ecclestone. If, as looks likely, EM.TV does not repay this by September, Kirch will take more of its SLEC shares instead, pushing its own stake up to 58% and EM.TV's down to 17%. Mr Ecclestone will still own the rest.

The future of Formula One is still not entirely clear, even though the car manufacturers recently signed a new 100-year commercial-rights deal with SLEC. The car companies briefly threatened to set up a rival motor-racing competition, but relented after Kirch promised to keep the races on free television, and not shift them to its pay channels. However, the car makers have not yet replied to an offer by Kirch and EM.TV of a 25% stake in SLEC. With the Formula One season well under way, they presumably have their minds on events on the track.

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Back office to the world

May 3rd 2001 | BANGALORE, DELHI AND MUMBAI
From The Economist print edition

India has high hopes for its burgeoning trade in business-support services

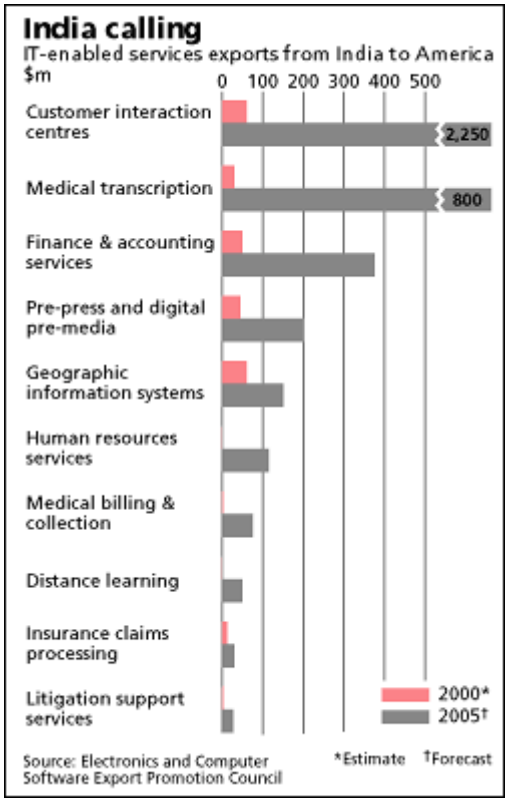
UNTIL a few months ago, Marc Vollenweider was a partner in the Delhi office of McKinsey, that most patrician of management consultancies. Mr Vollenweider, who is Swiss, is still in Delhi, but in a line of business that sounds almost plebeian by comparison: back-office work. He and his partner (lured from running the Delhi arm of IBM's research centre) have set up Evalueserve, a firm that undertakes various business processes for clients in Europe and North America, offering cheaper, better and faster service than they can deliver themselves.

Mr Vollenweider and his partner, Alok Aggarwal, were seduced by an irresistible proposition. First-world companies do lots of things that are expensive and necessary, and yet peripheral to their "core competence". The main requirement for these tasks is an intelligent English-speaking workforce—which India has in abundance, at a small fraction of rich-country wages.

So why not ship the work electronically to India, which missed out when the West sent much of its manufacturing to China and other points east? With admittedly suspicious precision, Mr Vollenweider has calculated that a typical western bank can outsource 17-24% of its cost base, reducing its cost-to-income ratio by 6-9 percentage points, and in many cases doubling its profits.

Such calculations have created a new industry in India that could, in theory, transform commerce in the developed world. The fizziest forecasts have come from Michael Dertouzos, director of MIT's Laboratory of Computer Science. He reckons that India has some 50m English-speakers who could each earn $20,000 a year—making a total of $1 trillion, twice India's current GDP—doing "office work proffered across space and time".

Other predictions are more restrained, but still heady. NASSCOM, India's main association of information-technology companies, thinks India will employ 1.1m people and earn $17 billion from what it calls IT-enabled services by 2008. A report to the Electronics and Computer Software Export Promotion Council (ESC), a government body, sees the industry's exports to America growing from $264m in 2000 to over $4 billion in 2005 (see charts).



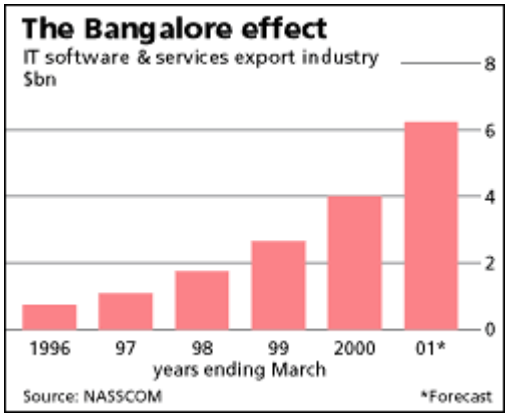
Yet India has been doing white-collar work for the rest of the world long enough to know that reaching targets such as these will not be easy. The new-born industry is already old enough to have tasted failure.

"Indian entrepreneurs look at riding the wave," says Sanjay Jain, a partner in Accenture, a consultancy. Earlier waves were the power industry, telecommunications and dotcoms. "Now the latest buzzword is IT-enabled services," he says—what this article will term teleworking.

Charismatic captives

The first riders of this particular wave have been of two types. One is “captive” operations of big western companies looking to reduce back-office costs without outsourcing. The other is more fleeting arrangements between western clients and subcontractors in India, often brokered by middlemen.

The first sort, which provide the bulk of employment in the business, have prospered. GE Capital Services opened India’s first international call centre in the mid-1990s. It now employs more than 5,000 people, whose jobs range from such relatively simple tasks as collecting money from delinquent credit-card users to such complex ones as data-mining. Swissair and British Airways have centres that run frequent-flyer programmes and the handling of errors in computer messages. American Express has a big back-office operation near Delhi.



Such companies often save 40-50% by shifting work from their home base to India. The savings may grow, because India’s telecoms costs, which are higher than in rich countries, are falling thanks to liberalisation. Shipping out more sophisticated services could also produce higher savings, because the salary gap between, say, an American or an Indian accountant is larger than that between an American high-school graduate and an Indian college graduate doing the same job.

Money is not the only attraction. No company will direct white-collar work to India for long if it does not get standards of service at least as high as those it is used to at home. Many Indian teleworking bosses claim to raise service quality. eFunds International, part of a company spun off from Deluxe, the biggest American printer of cheques, says that in Gurgaon, a suburb of Delhi, it has cut the number of errors in data processing for one client by 90%, and also cut the number of days taken to close the client’s monthly accounts from five to three. Rajeev Grover, eFunds’ head of “shared services”, says that Indian teleworkers outperform Americans in similar jobs because they treat them as serious careers, and also because they are better-educated than their American counterparts, who are often college drop-outs.

Shifting office work to India can also provide an opportunity to upgrade technology and service. Citigroup, an American financial giant, has an affiliate in Mumbai called e-Serve International, which employs 2,000 people to provide such services as the processing of documentation for letters of credit and the handling of questions over money transfers. e-Serve says that the time needed to respond to inquiries about global money transfers has been “drastically cut”. WebTek, a subsidiary of Germany’s Dresdner Bank, plans to use a shift in accounting work from London to Delhi as a chance to introduce “thin client” technology, which plucks from a computer only new data needed when a change is made, instead of always having to pick up an entire screen of data.

Insecure independents

Independent teleworking outfits have had a rockier time than captives. Too many crowded into the field too fast. One popular offering is medical transcription, in which companies convert dictation by doctors in America into written medical records. The report for ESC (conducted by Stevens International Consulting) estimates that India has 200 medical-transcription firms employing 10,000 transcribers. America sends enough work to India to employ only 6,000 of them. Bidding for business through middlemen, India’s glut of medical transcribers has driven the price of a line of transcription from 12 cents to as little as three, undermining both quality and profitability. Many firms in the business have gone bust.

A similar fate awaits some of the call centres that sprang up in the wake of GE’s success. Indian promoters hoped that, by filling a few rooms with speakers of mellifluous English, and by hooking them up to a bit of bandwidth, they could scoop up business from the American mid-west, from Ireland and from other call-centre clusters in rich countries. One entrepreneur tried to swap his sewing machines for handsets. But few bothered to set up marketing operations in their target countries, and many could not convince potential customers that they could do the job. Capacity use at Indian call centres is “abysmally low,” says Mr Jain of Accenture. He estimates that some $75m-100m of investment is idle.

There will, however, be life after the shake-out. Stevens expects the value of outsourcing in America of

medical transcriptions to double by 2005 to $4 billion, outstripping capacity. India could take as much as two-thirds of that increase, providing work to 45,000 transcribers. Similarly, outsourcing of work handled by call centres (now transformed into “contact centres” that can handle e-mail, fax and other media as well) is expected to go to India. Jones Lang LaSalle, a property firm, reports that people cannot put up fast enough the buildings needed for such centres.

Into this arena is stepping a new breed of entrepreneur, flaunting international savvy, management finesse and venture-capital finance. He does not skimp on bandwidth or any other technology; and nobody can describe his premises as a data sweatshop. His employees are encouraged to ponder careers with the company, and might even own stakes in it. He aspires to the professionalism of a GE or an American Express, but aims to serve many masters. Messrs Vollenweider and Aggarwal belong to this breed. So does Sanjeev Aggarwal (no relation), who set up Daksh.com, a contact centre that now employs 500 people. Yet another is Raman Roy, who left GE Capital Services to set up Spectramind, which has a similar-sized workforce. None of these firms is much more than a year old.

Many of the charismatic captives are themselves joining the ranks of the independents. eFunds (no longer part of Deluxe) has landed a second client and is eager for more; e-Serve is scouting avidly. British Airways and Swissair are selling services outside their groups. All are eyeing the $200 billion of “business-process outsourcing” that Dun & Bradstreet, a research firm, says is farmed out by companies worldwide. They see no reason why India should not claim a big chunk of that.

Mr Roy divides the teleworking pie into five slices, in ascending order of value:

• data entry and conversion, which includes medical transcription;

• rule-set processing, in which a worker makes judgments based on rules set by the customer. He might decide, for example, whether, under an airline’s rules, a passenger is allowed an upgrade to business class;

• problem-solving, in which the teleworker has more discretion—for example, to decide if an insurance claim should be paid;

• direct customer interaction, in which the teleworker handles more elaborate transactions with the client’s customers. Collecting delinquent payments from credit-card customers is one example, sorting out computer snags is another;

• expert “knowledge services”, which require specialists (with the help of a database). For example, a teleworker may predict how credit-card users’ behaviour will change if their credit rating improves.

Mr Roy’s taxonomy, broad as it is, could be extended to just about any service that is deliverable over fibre-optic wire. Indian animators are putting virtual flesh on the skeleton ideas of American film makers. Indian lawyers are doing research for British and American firms. Indian engineers are designing construction projects and testing car parts for foreign clients. At the most rarefied end of the spectrum, Indian scientists are conducting basic research and development for western firms. In some cases, the availability of low-cost, high-quality expertise in India could transform the economics of the industries that they serve.

Most of the new entrepreneurs are aiming for the higher rungs of the value ladder, where competition is scarcer, returns are generous, and new technology does not threaten to make them redundant. Technologies that enable computers to interpret voice and handwriting, for instance, could eliminate the simplest “data capture” jobs, such as converting handwritten documents into electronic form. To avoid being swamped by copycats, Mr Vollenweider says he is erecting “as many barriers to entry as I can”—one of which is not to say much about what exactly he plans to sell.

The sales pitch is similar to that of India’s software houses, which have built an $8 billion business on the quality and price of Indian programming talent. There are differences, though, which work both for and against Indian teleworking. One is that, unlike software, where the shortage of manpower has long been acute (at least until the technology recession took hold), teleworking has ample scope to increase output, even at the top end. India “churns out vast numbers of PhDs,” says Mr Roy.

Another is that recession is less likely to hurt teleworkers, and may even help them. Cuts in IT investment by customers are leaving Indian software programmers idle. But teleworking firms are offering to reduce the cost of back-office processes that are indispensable. Thus, while the notoriously

profitless Amazon.com has cut customer-service jobs in Seattle, it has added positions in Gurgaon through Daksh.com.

Why, then, are teleworkers collecting merely millions, rather than the billions that their cousins in software make? People in the business say it is easy to persuade chief executives of the virtues of doing white-collar work in India, but rather harder to convert those who must actually execute the change—"the people whose world you're going to shrink," as Mr Roy calls them. They find any number of excuses to resist, especially if the prospective contractor is independent rather than captive.

Dead lines

Excuses are not hard to find. India has a reputation, partly deserved, as a place where nothing works: the power cuts out and the telephone lines crackle and die. The services provided by the teleworkers are as exotic to most Indians as lychees are to most Americans: few Indians have chequebooks, let alone the 12,000 variations available to Deluxe's customers. Credit cards are even rarer.

Then there is confidentiality, a particularly big issue in health-related services. It is hard enough to keep up privacy standards at home; to trust strangers thousands of miles away seems to many foolhardy. The issue is not merely theoretical. Some American medical-transcription firms refuse to outsource work to India on grounds of privacy, despite potential savings of up to 50%.

To overcome the problem, the new breed of teleworkers invest a lot in reassurance. The office of Spectramind in Delhi, for example, is as slick as anything in Silicon Valley. Two generators back up the municipal power supply, and another generator backs up those two. If one telecom line breaks down, others take over. Sound-absorbent ceiling tiles are imported from America, and the name tags of Spectramind's workers report their blood types, in case anybody needs an on-the-job transfusion.

In the quest for seamless connections with their clients, call centres often give their staff American pseudonyms and train them to speak like Americans, a practice that has become something of a national joke (and a badge of shame, in the eyes of some commentators). The workers at Daksh, a Sanskrit word that the company translates as "utter preparedness to act immediately with supreme urgency", sometimes, refreshingly, use their real names in handling inquiries from customers of their clients.

The new teleworkers increasingly try to absorb the specific corporate culture of their clients. Sanjeev Aggarwal, Daksh's chief executive, talks not of outsourcing but of "co-sourcing". When Daksh signs up a client it sends over a ten-man team to learn its procedures and study its culture. On its return, the team becomes the client's "ambassador for driving the entire work ethic." For example, one person at Daksh "almost reports" to Bill Price, Amazon's vice-president of customer service, says Mr Aggarwal. Mr Price agrees. Daksh's Gurgaon centre, he says, "is virtually part of our operation".

Fulfilling Amazon-style promises to customers is not second nature for workers who have probably never shopped online for anything in their lives. Firms in the business, therefore, train all the time. At Daksh, training is not part of the "human-resources" function but a department in its own right.

India is such a tough place to operate in, the new firms argue, that only a local outfit can deal with the hassles. But many are still poor at attracting foreign clients. Some are simply not trying hard enough: they have built up impressive operations at home, but they have so far neglected to establish strong marketing arms in the countries in which their main prospective customers are to be found. Former captives such as e-Serve and eFunds have an edge over the local start-ups. Their international networks are denser and their pockets deeper, a comfort to clients looking for long-term relationships.

Whatever the fate of the individual enterprises chasing it, the pot of gold is too alluring to be ignored. Consider two examples from outside mainstream "business-process outsourcing". Crest Communications, a Mumbai-based company, spent four years and a couple of million dollars training special-effects artists and building a 40-seat computer graphics studio for them. To exploit this fully required further investment: the acquisition eight months ago of an independent Hollywood producer called Rich Animation, which has produced films such as "Swan Princess".

Rich/Crest's next feature will be written and dubbed in Los Angeles, but Crest's animators will do most of the rest, creating the look of the film from the sketches that Rich sends over. Crest promises savings big enough to change the economics of film making. "Mad" Max Madhavan, head of international business, claims that Crest can produce a film like "Toy Story 2" for little more than half its American cost.

The acme of teleworking occupies a spanking new building in a technology park near Bangalore—the John F. Welch Technology Centre, which is to double GE's research and development capacity within three years. (GE, incidentally, now employs more people in India than in America.) Less than two years after opening its doors, the centre employs 600 people, nearly a third of them with PhDs. GE plans to double that number by October. "The pipeline of advanced scientists is unlimited," says the facility's director, Jean Heuschen.

The abundance is such that GE can deploy 60 scientists on its plastics business alone. They are available at a cost that makes some projects that would have failed the profitability test more viable. "Now you have finance people who like R&D," says Mr Heuschen, with glee and wonder. "All of a sudden they say, give me more."

With accolades like this, white-collar work may shift to India even faster than some forecasters expect. Consider exlService, a teleworking outfit started in 1999 by Gary Wendt, ex-head of GE Capital. Mr Wendt later became boss of Conseco, a financial group in Indiana, and soon persuaded it to buy his Indian firm for $53m. Exl is now doing a roaring business: Conseco plans to shift 2,000 jobs from Indiana to India, saving over $30m a year. In America these jobs suffered from high turnover and quality problems over customer service. If moving to Exl solves these problems, as well as saving money, other American companies seem sure to join the stampede that is turning India into the world's back office.

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Dreams of a cashless society

May 3rd 2001
From The Economist print edition

It remains a challenge to connect futuristic payment methods to a 14th-century banking system

WHISPERING into your wristwatch or waving your mobile phone could one day be enough to trigger a whole host of (with luck, intentional) financial transactions. The bargain might be anything from paying a newsagent to downloading digital music, buying a train ticket, sending cash to a relative, or trading shares on the Internet.

In Finland you can already pay for a car-wash using your mobile. In Hong Kong you can walk through ticket barriers and buy fast food with a flourish of your Octopus stored-value card. In Russia you can buy a scratch-card to put money into a PayCash account on the Internet, to gamble or just to spend. Qpass lets you pay for articles from the online *Wall Street Journal*. Mobile-phone users in Germany, Austria and Spain can, in theory, use Paybox to pay for a taxi ride, or to send money to people in those countries. And there are virtual currencies, such as beenz, flooz, e-gold and Idollars, to be spent on the web and used as pay that avoids the tax man.

Every month brings closer the dream of a cashless society. Still, no new scheme has found a “killer application”, whatever its promoters may claim. This week Citigroup, a banking and insurance conglomerate, announced that it would use MSN, Microsoft’s Internet portal, for its online payment service, c2it, which it launched last year. In principle, the 7m people that are estimated to visit MSN’s portal a day can use c2it for Internet and person-to-person payments. But there is no guarantee that the giants’ partnership will thrive.

The challenge, as so many pioneers have found to their cost, is to predict, and then promote, a change in human behaviour. Typically, such changes are triggered as if by accident: successful examples are the pre-paid mobile phone (now 80% of the British market), or mobile-phone text-messaging.

Pressure for change is certainly there. Customers are impatient with banks that take three or four days to clear a payment. Even in euros, cross-border payments through banks can cost up to 25% of the amount sent. A Lombard banker of the 14th century would still recognise the system of correspondent banking today.

Credit cards are marginally better. They have established themselves over three decades as an easy means of virtual payment, especially across borders. Yet for merchants and consumers they are expensive both for very small payments on the Internet, and for very large ones. Besides, fraud is rife. On the Internet, credit-card issuers will not accept the risk of fraud, instead charging losses back to the merchant.

Enter PayPal, an American e-payment system, that has earned new respect from its rivals for reaching “critical mass”, even promising to make a profit by July. For those bidding on eBay, the biggest Internet auction site, PayPal is now the most popular method of payment. It can be used for 1.5m other business websites, as well as for person-to-person payments. It claims nearly 7m users, with 25,000 joining every day in an example of “viral growth”: if you pay somebody via PayPal, he must join up to get the money or otherwise endure slow payment by cheque. You get $5 for joining, and $5 for recruiting somebody else.

PayPal grew swiftly from its launch in late 1999 because it was free for individuals and for vendors of goods. Last June PayPal began to ask 1.9% of the value of purchases from vendors taking in more than $100 a month. That change coincided with new rules in America curbing the sale of personal financial

details to third parties, something that was thought to have been part of PayPal's previous business plan. PayPal has recently encouraged more buyers away from using credit cards, by paying interest on deposits in a PayPal account. Money in such an account can be used for instant payments to other PayPal accounts.

Merchants who sell through PayPal pay two percentage points less than for credit-card transactions on the Internet. So PayPal is at last coming to be seen as a threat to the big credit-card companies such as Visa and MasterCard. Last week, Jon Prideaux, from Visa International in Europe, admitted to a "growing respect for PayPal's fleetness of foot".

Credit cards account for around half of all transactions on the Internet—though that is still a mere 2% of all credit-card business, almost all of which is done at point of sale (in shops and restaurants) or by telephone. That may explain why credit-card companies have been so flat-footed about the next step in electronic payments: digital identification to make Internet and other remote payments more secure.

Most of the pilot projects with more intelligent credit cards (or other "smart" cards) have been a disaster. Visa and Barclaycard admit to problems with the latest Europe-wide project, called 3D SET, which has already been rejected in America by Visa's member banks. Now card companies and mobile-phone makers are wrangling over whether the SIM (subscriber identity module) cards in GSM mobile phones should double up as payment cards, or whether telephones should have credit-card slots too. Who dares predict which system we earthlings will favour?

Mondex, one of the early stored-value cards, launched by British banks in 1994, is still the best tool for creating virtual cash. Mondex cards are used on a handful of university campuses in Britain, but their marketing has not been brilliant. Perhaps only coercion, by municipalities or institutions, will persuade people to use such cards in preference to small change. (Not coincidentally, Singapore may be the first country to force merchants to accept electronic money as legal tender, albeit not until 2008.) In Belgium and Germany, millions of people carry bank cards with an additional, virtual-cash function, but few use it. According to 1999 figures collected by the European Central Bank, for every 1,000 cardholders, only 20 made a virtual-cash transaction on any day in Belgium, two in Finland, and just one in Germany. Virtual cash accounted for 0.003% of the euro area's M3 money supply.

It seems that banks are going to keep their grip over the start and finish of each payment transaction, whether physical or virtual. Meanwhile, there is scope for reducing the time that payments take to clear and settle—from three or four days to one day or less. Some e-payment ventures try to help to achieve this, rather than to become deposit-takers themselves. Purseus intends to harness the banks' own message system, SWIFT, to speed up the settlement of customer payments between banks. Earthport has launched a service, sendcash, which cuts the cost (to 20p, or 29 cents) and time (to two days) of cross-border payments in sterling, dollars, D-marks and French francs; it plans to add 11 more currencies. Paybox aggregates members' payments that need to be settled across borders—so far, between Germany, Austria and Spain. Because it is majority-owned by Deutsche Bank, other banks have been slow to add their support.

PayPal, the market leader in dollars, wants to add sterling and euros for European users. Europe has stricter e-money rules than America, with some countries (such as France and Germany) limiting the business to banks. That may prompt PayPal to start first in Britain or the Netherlands, where attitudes are more relaxed, or to cover Europe from its base in Palo Alto, California.

So what date does *The Economist* put on the death of physical cash? When the busker in Piccadilly takes donations on his mobile.

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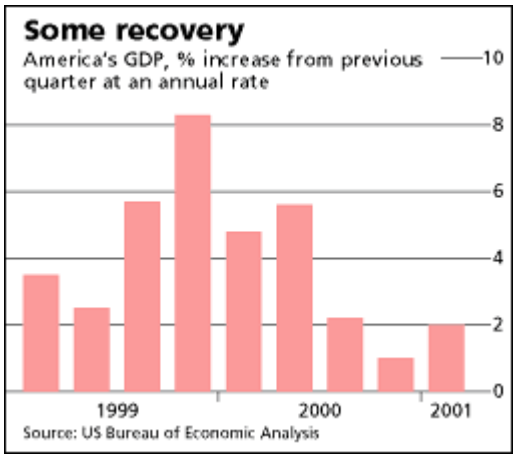
The American economy

The dawn?

May 3rd 2001
From The Economist print edition

AMERICA'S GDP expanded at an annual rate of 2% in the first quarter of this year, twice as fast as had been expected. Does this mean that economic commentators (including ourselves) have been wrong to fret about the risk of a recession, and that the Federal Reserve does not need to cut interest rates again? Unfortunately, the risks remain.

On the face of it, the GDP figures were surprisingly strong. Consumer spending grew at an annual rate of 3.1%, a bit stronger than in the previous quarter. Total real business investment rose by 1.1%, much better than might have been expected from the dispiriting profit figures that American companies have been reporting.



Look behind the aggregate numbers, however, and investment is less robust. Excluding buildings, business investment fell by 2% in the first quarter. Investment in information-technology equipment and software fell at an annual rate of 6.5% in real terms. In nominal terms, IT spending plunged by 13%, because prices of computers and the like fell sharply. That was the first decline in high-tech spending for a decade. A sharp slump in new orders for electronic goods suggests that bigger cuts in IT spending are in the pipeline.

The boom in high-tech shares in recent years pushed capital costs down to virtually zero, which has caused firms to overinvest in IT equipment. A new study by Credit Suisse First Boston says that American firms overspent by $190 billion over the past two years. The bank reckons that IT investment needs to fall by an average of 16% in volume terms this year and next to eliminate that overhang. That, in turn, would imply an annual fall of 8% in total business investment.

On the other hand, one bit of good news is that firms have reduced their inventories by more than expected. This reduces the risk of a big drop in inventories—and hence output—during the second quarter. Manufacturing remains in recession. The National Association of Purchasing Managers' index was virtually unchanged, at 43.2 in April; so long as it remains below 50, manufacturing activity will continue to shrink. Also in April, vehicle sales fell sharply for the second month running.

For the economy as a whole, *The Economist*'s latest poll of forecasters has an average prediction for GDP growth this year of 1.5%, up from 1.4% last month (see article). If that proves right, recession will be avoided, but the drop from 5% growth in 2000 would still be one of the biggest between any two years in the past quarter-century.

Despite the biggest 12-month fall in share prices since 1973-74, and corporate announcements of increasing lay-offs, American consumers continue to spend. One symptom is that the housing market remains strong, and households have taken advantage of lower interest rates to refinance their mortgages on more favourable terms.

The risk to consumer spending is jobs. New unemployment claims have risen to a weekly average of around 400,000 over the past month, up from 270,000 a year ago, and the highest for more than eight years. Full unemployment figures for April, due to be released on May 4th, were expected to show another rise in the official unemployment rate. If this continues, consumer spending will probably weaken in the current quarter. The sharper the increase in the jobless rate, the greater the likelihood that the Federal Reserve will cut interest rates again at its next policy meeting on May 15th.

The first-quarter GDP figures were good news, but one should remember that they are not set in stone.

When an economy slows sharply, growth is often overstated at first, and later revised down. This is because initial GDP numbers include estimates for some components of GDP that are derived by extrapolating recent trends (ie, from a period when the economy was growing faster). In the third quarter of 1990 initial estimates showed that GDP had risen by an annualised 1.8%. Revised figures later showed that the economy had actually slipped into its first quarter of recession.

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Venture capital

Under water

May 3rd 2001 | SAN FRANCISCO
From The Economist print edition

ASK Allen Morgan how his first two years as a venture capitalist have been, and the partner at Mayfield, a leading Silicon Valley venture-capital firm, will tell you that they have been “average”. The first year, he says with a grin, was probably America’s best-ever in high-risk financing. It was followed by one of the worst.

Until last summer, venture capitalists were the frenetic financiers of the “new economy”. They have since drastically cut the money they invest in high-tech start-ups: by $6.7 billion, or 40%, in the first three months of the year, compared with the previous quarter, according to PricewaterhouseCoopers. They have become the villains of the Valley. Yet both sides still need each other. For the funds available for investment have not dried up.

The latest gyrations, say the venture capitalists, are a textbook example of market forces at work. A run of record-setting initial public offerings (IPOs) of Internet start-ups, leading to returns on venture capital that averaged 165% in 1999, attracted ever more money and new entrants. Last year American funds collected almost $70 billion, seven times more than in 1995. In those six years, the number of venture-capital firms more than doubled, to over 1,000.

In 1999 and early 2000, entrepreneurs could, in essence, auction their business plans to the highest bidder. Many start-ups found funding within minutes. Average valuations of high-tech start-ups rose from about $11m in 1996 to almost $30m in 2000.

Today the balance of power has switched. Most venture capitalists are pulling the plug on the weakest firms, leaving questionable cases to fend for themselves, while focusing their energies on overseeing the most promising start-ups. A case in point is Angel Investors. From 1998 to 2000, the firm invested in 210 Internet start-ups. By the end of March, 45 had gone out of business and 30 were, in essence, abandoned. Ron Conway, a partner with the firm, hopes that the rest will at least give investors their money back.

Many funds are already under water. Although the average return on venture capital was healthy enough last year, at 37.6%, it fell by 6.3% in the final quarter, according to Venture Economics, a market-research firm.

Early-stage firms can still raise money, but only if they have good technology and a management team with more experience than pimples. Recently, Rearden Steel Technologies, a firm founded by Steve Perlman, a Silicon Valley veteran, which is developing computerised technology for home entertainment, said it had raised $67m. Yet start-ups looking for follow-on financing often cannot even get their calls returned.

What financing there is comes on exceptionally tough terms. Some venture capitalists set performance targets and dribble out funding as a company meets them. Others demand a steep “liquidation preference”, meaning that investors get a guaranteed return in the event of a sale or flotation, even before the founders and staff see a penny.

Small wonder that the latter are feeling mutinous; investors have, after all, pushed start-ups to grow as fast as possible. In early March, most of the employees of Livemind, a San Francisco wireless start-up, refused to go to work after the company’s main investor demanded four times its money back on a $3m loan. The protest didn’t help, however. The venture firm withdrew its offer, and Livemind closed.

Trade sales of companies are now less frequent, and smaller. Their average size dropped by 45% in the first quarter of this year, according to VentureOne, another market-research firm. Acquirers such as Cisco Systems, which devoured a dozen firms a year, have all but stopped buying.

Many venture capitalists say they welcome the swing of the pendulum. The best companies are those that are forged in such a downturn, argues Jonathan Feiber, partner at Mohr, Davidow Ventures. Entrepreneurs who want to start a company now, he claims, are not interested in a “quick flip” to make money, but in building something more durable.

Venture-capital firms cannot afford to be too averse to risk. Their coffers are full and, amazingly, getting fuller. In the first quarter of this year, investors committed $24.4 billion to private-equity funds—a record, according to VentureWire Group, another market researcher. Although this flood of capital will ease in the coming months, it is unlikely to drop to the levels prevailing before the Internet craze. Many pension funds and other institutional investors now set aside a certain percentage of their investment portfolios for private equity.

All this money will be waiting for the IPO market to come alive again. Should it do so, there is not much likelihood that the venture-capital industry will be more disciplined than it was in the days, just past, of greed and hysteria. Sitting on the sidelines is not something a venture capitalist likes to do.

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ECONOMICS FOCUS

Huff, puff and pay

May 3rd 2001
From The Economist print edition

There is plenty of support for the principle of simplifying IMF conditionality. Putting it into practice is another matter

Get article background

LIKE any new boss, Horst Köhler, who is coming to the end of his first year as managing director of the International Monetary Fund, wants to make his mark. From the outset, Mr Köhler wanted to bring more focus to what the IMF does, and to set clear priorities. His approach can be summed up as less means more: smaller rescue packages for countries needing IMF help, and fewer, but more effectively applied, conditions for those packages. He wanted the Fund to be better both at crisis management and at crisis prevention.

So far, it has not gone as smoothly as Mr Köhler had hoped. The reforms he brought in to make the Fund better at spotting trouble ahead are only now being implemented. It is too soon to know how effective they will be (the sceptics are, well, sceptical). On crisis management, too, the jury is out: Turkey, for instance, has been in almost continuous negotiation with the Fund since last autumn, and Mr Köhler has admitted that, if the Turkish government fails to deliver on its promises to the IMF for a third time, his reputation could be damaged. Nor are IMF packages noticeably smaller. The bailouts agreed for Turkey and, more recently, Argentina seemed pretty big to most people.

On conditionality, though, Mr Köhler seems to be making some headway. At last weekend's spring meetings of the World Bank and the IMF, he secured backing for his proposed changes in the way conditionality is applied. Countries getting financial support from the Fund cannot be expected to do everything at once, says Mr Köhler. It is necessary to decide on priorities, and to focus conditionality on measures that are critical to the macroeconomic objectives of recipient-country programmes, leaving those countries some scope to make policy choices for themselves. One benefit of this more streamlined approach, in Mr Köhler's view, is that it gives debtor countries the chance to build political support at home for their reform programmes—a vital element whose absence has, on occasion, caused IMF-sponsored programmes to collapse in the face of local opposition.

This new approach was endorsed by the main policymaking body of the IMF, the International Monetary and Financial Committee, when it met on April 29th. Its communiqué noted that streamlining conditionality shifts "the presumption of coverage from one of comprehensiveness to one of parsimony." This echoes what some Fund-watchers have been urging for some time. Morris Goldstein of the Institute for International Economics (IIE), a Washington think-tank, has long argued that the approach of IMF staff to conditionality has got out of hand. Mr Goldstein is not suggesting that IMF funds should be disbursed without strings. But he has questioned the sharp rise in the number of conditions attached to programmes (140 at its peak in the case of Indonesia, for example). Efforts to include in conditionality everything but the kitchen sink, says Mr Goldstein, have brought legitimate charges of "mission creep".

One of the consequences of this is that monitoring compliance becomes more difficult. For instance, is a country compliant or non-compliant when it observes 30 out of 50 conditions? It is hard to tell, says Mr Goldstein, in an updated paper recently published by the IIE*.

Mr Goldstein is no enemy of the IMF, rather a constructive critic. He was, indeed, an IMF staff member for nearly 25 years, and deputy director of the research department for seven. Yet the prickly reaction

that his views on conditionality have drawn from some Fund staffers shows that Mr Köhler needs support from below, as well as above, if the new policy is to be effective. At a recent seminar in Washington, for instance, one IMF official asked whether it was wrong to include measures aimed at poverty reduction.

Of course it is not. Even so, such efforts may be misguided. They may also be over-ambitious, given the finite resources and expertise within the Fund for monitoring compliance. After all, most IMF funding is not directly aimed at poverty reduction *per se*, but at helping countries to achieve the macroeconomic and financial stability that are the foundations of prosperity. Better, surely, to limit the number of conditions that countries seeking assistance should be asked to meet, and then to ensure that they do indeed meet them.

If eliminating mission "creep" is going to be a struggle, so too is cutting back on mission "push"—the desire of the IMF's biggest shareholders to get the Fund to take on extra responsibilities, sometimes even as they are voicing support for streamlining conditionality. The IMF, for instance, is now expected to play a leading role in combating money-laundering and financial abuse. This weekend's communiqué also endorsed the idea that the Fund should deal with corruption and poor governance. These are important aspects of sustainable economic reform. But they could imply an extension, not a reduction, of Fund involvement in domestic policymaking.

The fact is that it often suits the rich countries that largely dictate IMF policies to tack on specific conditions to individual country packages. They may talk about giving more focus to the Fund's activities, but in practice they find them useful policy tools, especially if they want to avoid the expense and bother of bilateral help. This is true, above all, for America—much the biggest shareholder in the Fund with, in effect, right of veto. The new Bush administration came into office amid expectations that they would be tougher on countries in trouble, and that they would oppose big bailouts. So far, though, their approach has been wholly pragmatic: after much huffing and puffing, the packages for Turkey and Argentina won strong American backing.

For the time being, at least, this has put the IMF in a stronger position than it might have hoped. Whether Mr Köhler can exploit this to make what the Fund does more effective will be a good test of his mettle.

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* "IMF Structural Conditionality: How Much Is Too Much?" Institute for International Economics working paper, April 2001.

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Mobile-phone charges abroad

Predatory roaming

May 3rd 2001
From The Economist print edition

THEY were in the bank, toting guns, as lots of money happened to go from the vault. That was the essence of last week's claim by Mario Monti, the European Union's competition commissioner, that mobile-phone operators have gouged customers by colluding to raise rates for roaming—ie, when you use your mobile phone abroad. Mr Monti's case is circumstantial, but he says the network operators will have to answer it.

In December Mr Monti's office issued a report on the market for roaming. Most countries in the European Economic Area (EEA), the report found, have a roaming market that is ripe for collusion. The product is undifferentiated, and the number of sellers small. Pricing in the wholesale market is transparent, making it easy for a market leader to raise prices, and for other operators to take the hint and follow suit. The costs of running mobile networks do not vary that much. As a result, says the report, sellers' pricing structures tend to run in parallel, at "high and rigid" levels. Mr Monti cites "an almost complete absence of competition", and says that "prices appear to be converging", towards *euro*1 (89 cents) a minute.

To be fair, the conditions for collusion, apart from the small number of sellers cited above, could also be present in a perfectly competitive market. And retail prices in Europe are not quite as similar as Mr Monti's comments suggest (see table). For a call from Belgium to Britain today, using a British mobile phone, rates range from 51p (73 cents) to 99p a minute. Rates for receiving calls also vary widely. On One2One, a monthly charge of only £2.50 can lower the receiving rate from 76p to 16p. That is an indication of just how low the marginal cost of roaming calls might be.

Looking closely at wholesale rates, the commission found that the cheapest in Europe were about *euro*0.46 a minute. In Belgium, Britain, the Netherlands and Norway, some operators had rates at least twice as high as the average of the five cheapest. Yet even the lowest wholesale rates in Europe may be gouging consumers. Just look at what is on offer in North America. MicroCellnet, a Canadian operator that has 1m customers, recently launched a flat-rate American roaming service: for customers on a standard monthly service agreement, the retail price of calls made anywhere to Canada or within the United States is 20 cents a minute—less than half even the lowest wholesale rates in Europe.

Innocents abroad

Roaming rates per minute, pence for British phones in Belgium*

British operator	Belgian partner	Placing a call	Receiving a call
BT Cellnet	all	99	94
One2One	Mobistar	77 (58)	82 (76)
	Orange	91	82 (76)
	Proximus	81 (61)	82 (76)
Orange	all	60	30
Vodafone	Proximus	51	25.5
	all others	59.6	25.5

*Figures in brackets are off-peak rates

Source: Phone companies

Perhaps Europe's costs are so different from North America's that they justify BT Cellnet's roaming rate of 99p a minute? It seems unlikely. Chris Doyle, an economist at Charles River Associates, points out that roaming generates up to 35% of European operators' revenues, although it accounts for a much smaller share of the time customers spend on the telephone. Asked exactly what costs and market forces determine its roaming rates, BT Cellnet says the question is "too commercially sensitive to answer".

Market concentration also points to a lack of competition. In each of 11 EEA countries, a single operator had a market share of at least 50%. Still, the biggest obstacle to a competitive market for roaming may be the ease with which the operators can exploit consumers. They have little incentive to compete over roaming rates—to quit the cartel, Mr Monti might say—since mobile users do not usually use rates abroad as a basis for choosing a provider. Few customers know how much they are paying for roaming. Even fewer actively choose which local network to roam on.

The commission's report recommends making choice easier for consumers. In the best of worlds, roamers would be able to get rate information piped through to their telephones from various providers, before choosing which service to use. Mr Doyle believes that call-back services, which allow roamers to replace higher calling fees with lower receiving fees, will put pressure on operators to cut rates. If the commission wants to see rates fall swiftly, however, it will have to take action itself.

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Micro-meddler

May 3rd 2001 | SEOUL
From The Economist print edition

POWER, but no responsibility: these were long the qualities of South Korea's finance ministry, and they helped to push the country to the brink of bankruptcy three years ago. The ministry was suitably chastised: one minister was jailed for negligence (though he was later acquitted by the supreme court), and it was forced to hand over some of its rights, such as licensing financial-services firms, to the Financial Supervisory Service (FSS), a newly created banking watchdog. In practice, little has changed. The finance ministry, with power restored, today still meddles in the economy, by pulling strings at nationalised banks. It is even trying to regain control over the FSS.

Recently the finance ministry announced plans to revamp a regulatory structure that is only two years old. At the top of the structure sits the Financial Supervisory Commission (FSC), responsible for setting the rules for the financial industry. It is the job of the FSS to enforce those rules. The structure is not entirely satisfactory. Lines between the two bodies are blurred, and the chairman of the commission is a political appointee who also heads the FSS.

The best thing would be to crunch the two tiers into one. Instead, the ministry says it will set up a secretariat within the supervisory commission. It is to be staffed by dozens of finance-ministry bureaucrats who will, in practice, oversee the FSS. Regulators at the FSS threaten to resign, claiming that the scheme will undermine their agency's autonomy.

Since the government owns several banks that were nationalised during the financial crisis of 1997-98 and put under the finance ministry's wing, autonomy for supervisors ought really to be strengthened, not weakened. The government has spent more than $100 billion trying to restore ailing financial institutions to health. Today, it owns several big commercial banks, two of the three biggest investment trusts and a life insurer. Indirectly, through the banks, the government owns some truly big companies, such as Daewoo, Ssangyong and, soon, Hyundai: it has these holdings because the banks swapped the firms' debt for equity.

The banks have a mandate to restructure struggling firms. Yet they suffer from a shortage of talent. And they are not completely free to let insolvent companies go under: the government fears rising unemployment.

Take the case of the Hyundai group. At least four subsidiaries are in deep trouble, with debts of some 20 trillion won ($15.1 billion), equivalent almost to the combined equity of all 17 of the country's commercial banks. The finance ministry is urging creditor banks to rescue Hyundai's construction arm by swapping 1.4 trillion won of debts for equity and buying new shares worth 765 billion won. Will they oblige? When Daewoo collapsed nearly three years ago, bondholders were compensated at almost full face value. Hyundai bondholders are likely to expect the same. Either way, it is not easy, in the face of conflicting demands, to see how the banks can be turned around.

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Soft commissions in Britain

Hard to stop

May 3rd 2001
From The Economist print edition

ONLY two out of 200 pages in Paul Myners's recent, sweeping review of institutional fund management in Britain discuss the matter of stockbroking commissions. Yet his recommendation that fund managers should pay for the services that stockbrokers provide, rather than pass the cost on to the corporate pension funds they run, has become the most hotly debated of his reform proposals. Even executives at Gartmore, the investment-management firm that Mr Myners chairs when he is not writing reform plans for the chancellor of the exchequer, have criticised their boss for this proposal. The Fund Managers' Association has been positively alarmist, giving a warning that British fund managers would be at a competitive disadvantage if they had to pay brokers for their services.

Why are the ways brokers are paid so controversial? There are two sorts of broking commissions: the usual percentage of a share trade and "soft" commissions. There are also two types of brokers: full-service brokers and soft ones. Old-fashioned, full-service brokers, such as Cazenove, get a "traditional" commission on each share transaction, for a bundle of services that include research as well as the execution of the transaction. Soft brokers work differently: they provide fund managers with inducements—say, a Reuters screen or research reports—in the hope that fund managers will channel business in their direction. If they do, the broker recovers the cost of the inducement, and with luck more. If the fund manager cannot use or does not want the services of the soft broker, he will lose them or may even get an invoice for the Reuters screen at the year's end.

Mr Myners campaigns for a fund-management fee that is all-inclusive, and for an end to the practice of "softing". In his view, fund managers, being human, are less conscious of costs when they choose a broker, because the bill is now picked up by the pension funds they manage. He thinks fund managers prefer to use a broker's proprietary research (however mediocre), rather than hire their own research analysts, because they would have to pay these directly.

Soft commissions create an even stronger bias for fund managers to rely on the services of brokers. A fund manager will be reluctant to consider switching from a broker who offers soft credit, even if the service is better elsewhere. And he will be tempted to shuffle a client's portfolio rather more often than necessary. Each trade generates a commission and is therefore a step closer to paying off the Reuters screen.

Many fund-management firms and stockbrokers in Britain are jumping to defend the present system. They argue that high commissions affect a fund manager's performance, which is measured after all charges, including commissions. Fund managers are thus likely to be careful not to overpay brokers, they say, even if it is other people's money that they are spending. They say a radical overhaul of the commission system in Britain makes little sense when America, the world's largest equity market, will continue with today's arrangements, soft commissions and all. (Softing is more generous and more widely used in America than in Britain.) To have a different commission system from international peers would put British fund managers at a disadvantage, or so say London money-men. At the least, they would have to put up their management fees.

Soft commissions have fewer defenders than traditional commissions (the two are not incompatible, of course). Some fund managers do not engage in softing—on principle, they say. Still, soft commissions are less murky than their reputation has it. In Britain, the Financial Services Authority tightly regulates soft commissions. Brokers and fund managers must declare them, like any other form of commission, as they do in America. Moreover, an end to soft commissions would put some agency brokers out of business, so reducing diversity in the market. It would disadvantage small fund-management start-ups that badly need initial help from soft brokers. Not everybody thinks that the trend towards a handful of huge fund-management firms is a healthy one.

Mr Myners is undeterred by these arguments. In his eyes, Britain should pioneer a system that provides better value for money. Many of the commissions, hard or soft, that pension funds end up paying go, for instance, into research reports that lie unread. One of fund managers' most frequent complaints is over

the huge quantity and poor quality of research from financial behemoths that are keener to please their investment-banking clients than to provide critical research. Investment banks' conflict of interest helps explain why a recent survey of fund managers, by Tempest, a consultancy, found that many managers increasingly resort to their own, in-house research, despite its extra cost.

Mr Myners's proposals would encourage this trend. More fund-management firms would then have in-house trading desks, or use brokers who simply execute deals. In addition, they would become more selective about buying outside research reports. You can see why the stockbrokers oppose the report. Mr Myners has taken on a powerful lobby. He has the backing of the chancellor of the exchequer, but not even Gordon Brown can make fund managers subscribe to a "voluntary" new code of practice to which they are opposed.

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The line of least resistance

May 3rd 2001
From The Economist print edition

Understanding the biochemistry of bacteria will lead to more relaxed bacteria—and healthier humans

GENETICISTS have long promised that their science will bring a revolution to medicine. Yet like all revolutions, this one has had its victims. It has been built on the corpses of legions of bacteria that have perished in the course of decades of research. Now other bacteria may reap the benefits of this sacrifice. Using information gleaned from studies of bacterial biology, researchers are designing medicines that will cure people, while also giving bacteria a bit of a rest.

That may sound odd: surely the point of medicine is to kill bacteria, not to cultivate them? But trying to exterminate bacteria has had nasty consequences. An antibiotic kills the weakest specimens in a population. Those that are resistant to the drug survive and resume breeding. Over time, the resistant strains outnumber the susceptible ones—and the antibiotic becomes useless.

Worries about antibiotic resistance now loom large. Last year, America's Food and Drug Administration approved Zyvox, a drug that introduced a new class of antibiotics to patients for the first time in 25 years. But in April John Quinn, of the University of Illinois at Chicago, and his colleagues reported in the *Lancet* that some people had developed infections resistant to the new drug after using it for only three weeks.

In March, America's Centres for Disease Control published a new set of guidelines for controlling and reducing the dosage of antibiotics in patients. Agricultural use is a problem, too. According to the Union of Concerned Scientists, based in Cambridge, Massachusetts, around 70% of the antibiotics made in America go directly to farm animals, because dosed beasts grow larger. The hordes of antibacterial soaps and detergents in the shops also increase the pressure on wild bacteria to evolve resistance.

This state of affairs has a familiar ring to economists, who know it as the "tragedy of the commons". In the short term, each group—of doctors, farmers or vigilant housekeepers—overuses a common resource, to the detriment of all in the long term. The solution could lie in exploiting another idea beloved of economists, game theory, and tailoring it to the constraints imposed by natural selection. The idea is to slow the arms race between antibiotics and bacterial evolution, either by interfering with bacterial mechanisms of resistance or by suppressing them entirely.

Acting defensive

When a bacterium detects a dangerous chemical, it mounts a host of responses. One of the most important is to chew up the toxin with custom-made resistance enzymes. The natural precision of these enzymes has been a boon to medicine makers over the decades: chemists have been able to generate new varieties of antibiotic by tweaking the design of existing compounds just enough to fool the enzymes. If the resistance enzyme cannot recognise and destroy the new variety, the drug can do its work unhindered.

Natural selection, however, soon catches up. This has prompted researchers to look for ways to interfere

with the actions of the bacterial enzymes themselves. Gerard Wright and his colleagues at McMaster University in Ontario, Canada, found that some resistance enzymes bear a resemblance to a family of molecules known as the protein kinases. Because protein kinases seem to be involved in a variety of disorders, pharmaceutical and biotechnology companies have been looking into their structures for years. The resemblance between the two groups of compounds means that inhibitors of protein kinases also inhibit bacterial resistance enzymes. Dr Wright is now trying to find a way to reverse bacterial resistance by modifying one of these protein-kinase inhibitors.

Bacteria also safeguard themselves from toxins by turning on an “efflux” system, a form of cellular garbage-disposal that ejects any offending substance without further ado. The efflux mechanism is a molecule bound to a bacterium’s outer membrane. It locks on to the offending toxin and ejects it through the membrane. Some species of bacteria have several types of efflux system. Microcide, a firm based in Mountain View, California, has found a compound that attacks three of these systems in *Pseudomonas aeruginosa*. As hoped, this compound augmented the potency of antibiotics in mice infected with this pathogen.

Eventually, bacteria would evolve around such gimmicks, just as they evolved around antibiotics. The only way to stop this evolution is to neutralise the threat they pose without killing them too quickly in the process. That would slow down the arms race between the bacteria and the drug makers, and Michael Alekshun and Stuart Levy of Paratek Pharmaceuticals in Boston, Massachusetts, think they have found a way to do it. They have identified a regulon (a collection of genes whose expression is regulated by a single protein) in the genome of *Escherichia coli*. This regulon controls the bacteria’s defences against antibiotics.

When *E. coli* senses a dangerous chemical, a protein called MarA activates this regulon, which is known as Mar because its activation confers “multiple antibiotic resistance”. Mar starts up the cell’s efflux system, and also stops the cell from allowing any more threatening molecules in by halting the production of porin, a membrane protein that acts as a channel into the cell. Once the threat subsides, the MarR (for “Mar repressor”) protein turns off the Mar regulon, and the cell returns to its normal state.

To disguise an antibiotic attack from a bacterium, all that is needed is an increased concentration of MarR and a lowered concentration of MarA. This month, at a meeting of the American Society of Microbiology in Orlando, Florida, Dr Alekshun and Dr Levy will unveil the crystal structure of the MarR protein, a discovery that makes it easier to find molecules that will interact with it. They have started the hunt for molecules that will alter its function, and are also analysing a set of substances that inactivate MarA.

Initially, the researchers saw controlling the Mar regulon as a means to increase or restore the potency of existing antibiotics. That would be good, but would almost certainly result in the evolution of resistance in due course. Further experiments, though, produced an unexpected result. *E. coli* without MarA do not form communities.

Usually, as bacteria float past a congenial surface, they adhere to it and form a mass of accumulated layers called a “biofilm”. In time, they produce a sturdy sugary coat that guards the biofilm’s tenants from antibiotics. Infections are often the result of biofilms forming on soft tissues. But in the Petri dish, bacteria without MarA did not form biofilms. Dr Alekshun and Dr Levy believe that the Mar regulon must also control some important process related to biofilm formation.

If the phenomenon occurs in bodies, as well as glassware, then inactivating MarA would stop infections forming. Bacteria could not gain a foothold, and the host’s immune system could simply flush them out of the body. Antibiotics could then be used more sparingly. By the same token, bacteria could stop racing to improve as well: because a Mar-based drug would render bacteria harmless but would not kill them, it would not impose a strong selection pressure. Just as game theory suggests, a compromise that reduces the damage done by both sides can work to their mutual benefit. Sometimes mercy is more than its own reward—even when it is shown to germs.

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Digital watermarks

Facing the music

May 3rd 2001
From The Economist print edition

THE trouble with stirring up a hornet's nest is that you cannot complain when you get stung. Such a philosophical attitude, though, is beyond much of the music industry this week, as it faces public humiliation over flaws in its plans for the digital "watermarking" of music to prevent illicit copying.

Reuters

Copy me baby, one more time

The story began last year, when the industry, in the shape of the Secure Digital Music Initiative (SDMI), a consortium of 200 companies, challenged computer hackers to break any or all of six technologies devised to protect digitally recorded music. The hackers had a month, were offered up to $10,000 for each broken technology, and were invited to "show off" their skills. But when one group tried to do just that at the end of April, by announcing its findings at a conference, the SDMI attempted to stop its solution becoming public information.

One way of trying to prevent illicit copying is to insert a digital "watermark" into a file. This is a pattern of the ones and zeroes of which digital information is composed that identifies the copyright owner, and also what can be done with the file. It would then be necessary to arrange for all new music-playing equipment to be fitted with hardware that interprets this watermark appropriately. (This should be possible, since the SDMI includes the equipment manufacturers.) Such SDMI-compliant hardware might allow someone to duplicate his copy of, say, Britney Spears's "Oops, I did it again", but not make copies from those duplicates.

If digital watermarks can be detected, however—as is necessary for them to work at all—then it seems inevitable that somebody will be able to find a way of removing them. It was to pre-empt and test that inevitability that the SDMI issued its challenge. However, when Edward Felten, a researcher at Princeton University, and his colleagues at Rice University and Xerox's Palo Alto Research Centre, who had risen to the challenge, tried to tell the Fourth International Information-Hiding Workshop in Pittsburgh about their success, they were threatened with legal action by the SDMI. That tactic, which looked to many like an attempt to restrict academic freedom, backfired. The paper was leaked and republished on the web, drawing much wider attention than it otherwise would have done.

Dr Felten's team was given three songs to analyse for each SDMI–backed watermarking technology. Two were unmarked and marked versions of the same song; a third was a different song with the same watermark. The team made detailed comparisons of the watermarked and unwatermarked versions of the first song, and then analysed the two watermarked songs using their knowledge of past techniques for watermarking. For example, one approach is to add echoes to the music. An echo may be present or absent; the time delay between the primary signal and the echo can also vary. By manipulating these parameters, it is possible to insert a unique pattern of information into a file, ideally without altering what it sounds like when played.

The formal challenge was to remove the watermark from the second song, while maintaining its sound quality. Dr Felten says the team was able to do this for all four watermarking technologies without damaging the sound much (the other two technologies were meant to prevent an audio file being separated from the CD it came with).

Yet Verance Corporation of San Diego, a company that supplies one of the watermarking technologies, says that it was told by the SDMI that none of the 150 attacks on its watermark had been successful in removing it while maintaining quality of sound—implying that, despite the consortium's desire to stop Dr Felten going public, his method had not made the grade. The SDMI, meanwhile, will not say anything.

Whether or not the researchers met acceptable quality standards, what bodes ill for digital watermarking is that Dr Felten and his colleagues got such a long way with only three test files per technology. Hackers doing it for real would, if the use of such watermarks became widespread, have access to a large number of files for comparison. They would also have access to the watermark detectors built into equipment in order to stop the use of pirated material. The software inside this detector could—and, if the failed attempt to sell DVDs in versions that can be played only in certain parts of the world is anything to go by, probably would—be “reverse engineered” in order to figure out which watermarking technology was being employed, and so how to remove it.

The SDMI’s systems are supposed to provide the best of both worlds, allowing individuals to make unlimited personal copies of their CDs, while making it difficult to distribute such copies to other people. Their failure would involve an uncomfortable and expensive rethink for an industry that is worried enough as it is.

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A genetic paperchase

May 3rd 2001
From The Economist print edition

THERE is a difference between information and knowledge. With the completion of the Human Genome Project, biologists have a lot of information about what human genes are. Knowledge of how they work—and in particular of how their products interact to form the vast network of biochemical pathways referred to as "life"—is harder to assemble. But a group of biologists led by Eivind Hovig of the Norwegian Radium Hospital in Oslo has managed to find a way to speed the process up, by linking together the vast quantities of disconnected biochemical information that have already been published.

The source of this information, which is sometimes referred to as the biobibliome (after the genome, which is the set of all genes in an organism, and the proteome, which is the set of all proteins), is an electronic archive called MEDLINE. This contains more than 10m articles published in biomedical journals over the past 35 years. Dr Hovig's knowledge-creating tool, unveiled in this month's *Nature Genetics*, is a computer program that searches the titles and abstracts of these articles looking for "co-occurrences" of the names of genes in a single paper. The assumption is that co-occurrence implies a functional relationship, so that if A and B co-occur regularly, and B and C do so too, then the chances are that A, B and C are linked in a pathway.

This simple idea, which eliminates the tedium of searching for connections by hand, seems to work. When tested against biochemical networks established the old way (ie, in the laboratory), the results agreed often enough to make newly suggested links worth pursuing. And when the program searched for connections between genes that are known to be turned on in certain white blood cells, not only was it able to find new links between those genes, but, because papers published in MEDLINE routinely contain medical information, it also provided insight into the sorts of diseases, such as particular leukaemias, for which such connections might be significant.

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Cosmology

Inflated ideas

May 3rd 2001
From The Economist print edition

THE Big Bang which began it all was less, it seems, a clamorous noise than a precise chord. Researchers studying the microwave radiation that permeates space, and is the cooled remains of the gamma rays from the original explosion, have confirmed that it is a series of harmonics. This is music to the ears of cosmologists everywhere, since it bolsters their favourite theory of how the universe came into being: inflation.

According to inflation theory the early universe underwent a period of intense expansion for a fraction of a second after its creation, before settling down to its present, rather slower rate of growth. This idea solves several puzzles, the most pertinent being why matter is clumped together, rather than spread uniformly as a thin gas. Since this clumping is the reason that galaxies, stars, planets and—ultimately—people, exist, its origin is of some interest.

Inflation would have turned tiny, temporary fluctuations in the early universe into huge, permanent features by stretching them to the point where they could not vanish whence they came. These variations, in turn, produced compressions and expansions (in effect, sound waves) in the primordial gas. Since a gas heats up when it is compressed and cools when it expands, it is possible, by studying the hot and cold patches in the modern-day remnant of the ancient radiation, to listen to the universe's birth pangs.

At a recent meeting of the American Physical Society in Washington, DC, researchers from a project called the International Boomerang Collaboration presented their latest results on the microwave background, as it is known. These show that the patterns of hot and cold ripples in the background are consistent with inflation.

Preliminary data from the Boomerang experiment, which consists of a telescope suspended from a balloon high above the Antarctic, were published a year ago. These confirmed the presence of the largest ripples. The new results confirm the existence of higher "harmonics" (in other words, smaller ripples) and show that they have precisely the sizes predicted by inflation.

But it is not only the existence of higher harmonics that has physicists singing to themselves. The relative sizes of the first and second harmonics agree with another part of the existing cosmological theory. The new data show that the matter in the universe that makes up ordinary objects such as atoms and stars accounts for only about 5% of the universe's total mass and energy. The rest is so-called "dark" matter, whose exact nature remains mysterious.

The harmonics show the ratio of ordinary matter to dark matter, because the first harmonic relates to the quantity of matter of all varieties, and the second relates to the speed of sound in the primordial gas (which consisted only of ordinary matter). The figure of 5% agrees with an earlier analysis based on the amount of a form of heavy hydrogen called deuterium that was produced in the Big Bang. Inflation's boosters had been worried because last year's preliminary data suggested a figure nearer 6%, which would have been much too high.

The theory is not quite safe, even so. MAP, a satellite due to be launched by America's space agency, NASA, at the end of June, will measure the polarisation of the background radiation. That will test a theory put forward just a few weeks ago by Paul Steinhardt of Princeton University. Dr Steinhardt attempts to do away with inflation by proposing that the universe was "dormant" until struck by an offshoot of a hidden parallel universe. This theory predicts the same harmonics as does the inflationary theory, but it results in different polarisations. If the data from MAP showed those polarisations, it would be the first evidence that the universe itself may not be alone.

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A new wind out of East Asia

May 3rd 2001
From The Economist print edition

Modern-day life is now the focus of the best films from China

WHETHER you raved or yawned, there is no doubt that "Crouching Tiger, Hidden Dragon" from Taiwan marked the arrival of Asian cinema as a box-office staple in America and Europe. The balletic martial-arts adventure demonstrated its commercial reflexes by winning four Oscars and joining the select club of films making more than $100m at the box office in North America.

Reuters

Giving Chinese films a smile

Film scouts in search of such success in years past would have concentrated mostly on the Hong Kong film festival. But, surprising as it sounds, the really hot gathering for Asian films these days is in the foothills of the Julian Alps north-east of Venice, in the provincial Italian town of Udine. Every spring Udine mounts a one-week festival of the best East Asia has to offer.

Its festival this year, which ended last week, screened 73 movies, not all of them brilliant but sharing a strong common characteristic. These were not art films aimed at prize juries in festivals such as Cannes, Berlin and Venice, but the kind of intelligent movie that can nevertheless hope for a respectable box-office return. Imagine "Confucius in Love" or "Mandarin Beauty", and you will get a rough idea.

The most striking thing to emerge from Udine this year was a clear and novel trend in films from mainland China. Until now, contemporary Chinese film making has been identified in the West with historical peasant dramas of great visual beauty which allude only allegorically to modern-day politics or society. Among the most famous are "Yellow Earth" (1984) by Chen Kaige and "Raise the Red Lantern" (1991) by Zhang Yimou. But life in China's big cities was already quite unlike that when those films were made, and there has been more change since. A criticism of such films heard widely in China was that they were too narrowly artistic and did not relate directly enough to everyday life. Younger directors, to judge from Udine, have got the message.

The eye-opener was a Chinese film called "All the Way": a road movie that is also an off-beat romance that ought not to succeed but, given goodwill and a lot of luck, just might. It goes back to the basics of cinema, telling its story visually so that everything can be understood, whether you need to follow the subtitles or not. It is almost entirely comprehensible from the images alone and from the nuances of expression on the actors' faces.

"All the Way", which stars Karen Mok (above), was co-produced in China by Peter Loehr, an American who speaks fluent Mandarin and set up his own production unit there, Imar Film, which has now had four hits in a row, starting in 1998 with the irresistibly entitled "Spicy Love Soup". By keeping budgets low and targeting the big cities where his movies are likely to find their widest audience, Mr Loehr has so far struck lucky. He is under no illusions, though, and happily described his long-term goal as being in business in two years' time.

Directed by Shi Runjiu, who also made "A Beautiful New World" for Imar Film, "All the Way" evolves from a thriller involving a scam and a robbery into a cock-eyed love story that turns on the toss of a coin and the blatant trick that a very ordinary truck driver plays to ensure that heads he wins, tails she loses. In a Chinese context, where so many films still follow the party line, this is a fresh and exhilarating entertainment.

After a brave start in the 1980s, Huang Jianxin, another Chinese director, became known for cautious parodies touching mainly local chords and was widely thought of outside China as a spent force. He began with "The Black Cannon Incident" and "Signal Left, Turn Right", but then something went wrong and he seemed to lose his way. In "Tell Me Your Secret", however, Huang Jianxin has reinvented himself with a complete change of tack, revisiting the principles underlying post-war Italian neo-realism, in

particular Vittorio De Sica's film "Bicycle Thieves". From a small incident—here a hit-and-run accident—the film spirals out until it starts to call into question a whole range of apparent social certainties. The driver who has caused the accident quits the scene lest it undermine her family's social standing. But in the end she comes to recognise that her life is linked to others and that she must accept responsibility for her actions. This bald summary makes it sound stiff and teachy. But it is a beautifully crafted story with big ramifications.

Mr Huang is interesting for another reason. He was part of that so-called fifth generation of film makers who first opened the world's eyes to modern Chinese cinema but who fell foul of official opinion inside China. Many of these directors have found it difficult to adjust to the shifting demands of Chinese movie-going. The later films, for example, of Zhang Yimou ("Not One Less" and "The Road Home") have continued to win prizes at overseas festivals but have failed to recapture the sweeping confidence of his early masterpiece, "Raise the Red Lantern".

With "Tell Me Your Secret", Mr Huang has perhaps opened up a new avenue for Chinese cinema, with a gravity and moral force appropriate to modern times and urban living. It is one of the most encouraging developments in Chinese movies since that glorious burst of work a generation ago.

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American law

Wholesale attack

May 3rd 2001
From The Economist print edition

AMERICA'S complicated legal system has spawned a small but busy industry of books, magazine articles and opinion pieces excoriating its many flaws. The genre depends on the myriad cases thrown up every year which seem, at a glance, absurd: an old lady winning millions from McDonald's after spilling coffee in her own lap; a jury awarding billions against General Motors for a rear-end collision which the company did not cause; or local authorities dismantling children's playgrounds for fear of being sued.

Few are as adept, or persuasive, at mining this rich seam of anecdote as Philip Howard, a New York lawyer and writer. His first book, "The Death of Common Sense", ridiculed government regulation. His latest, "The Lost Art of Drawing the Line", targets Americans' taste for lawsuits.

THE LOST ART OF DRAWING THE LINE: HOW FAIRNESS WENT TOO FAR
By Philip K. Howard

Random House; 255 pages; $22.95

Buy it at
Amazon.com
Amazon.co.uk

Mr Howard writes well, punctuating his text with skilfully told tales and choice quotations from the good and wise. Unlike so many other critics of American law—who struggle to control their scorn—Mr Howard's tone throughout is that of an eminently reasonable man, one who sees all, or at least most, sides of any issue, but who nevertheless has enough courage and conviction to make the right choice. This makes his arguments seem very persuasive.

In fact, they are almost entirely bogus. Like so many other books of this type, Mr Howard's offers no reasonable prescriptions. Certainly the American legal system requires useful critics, and always will. That is because it is one of the world's most highly developed systems of arbitration, and is continually trying with varying success to balance clashing interests in a fair and open way. One consequence is that the rules by which it operates continually evolve, and in the process frequently move too far in one direction or another.

Mr Howard's response is to appeal to "common sense", and to call for government officials to be given back their freedom to act like "humans"—by which he seems to mean freedom to do what they think is right. This first appeal is specious. There is no such thing as an agreed "common sense" which can deal with every clash of interest or conflict of rights. That is one reason why cases end up before judges or juries. And letting government officials exercise authority unchecked by law is not something which most Americans, on reflection, would support.

Despite his moderate tone and feel for a quote, Mr Howard exaggerates. American officials as he sees it, are frozen into immobility for fear of lawsuits. He seems to believe that anyone at any time can foil the will of the nation by going to law, and that America is somehow imprisoned by over-rigid legal rules. Few who visit, let alone live in, the United States would recognise this overdrawn description of American government and society.

Picking out legal cases where the outcome seems silly is easy and entertaining. Cases of this kind can raise serious questions of whether a particular law, or the courts generally, are functioning well. There are several aspects of American law which seem to need reform—class-action suits, punitive damages in civil cases, criminal-sentencing policy, the death penalty, to name a few. But instead of attempting to face such issues, one by one, and suggest in detail how change could be achieved, Mr Howard and writers like him find it easier to rail against the system as a whole.

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America and the third world

Poor relations

May 3rd 2001
From The Economist print edition

THE IMPERIAL MANTLE: THE UNITED STATES, DECOLONIZATION, AND THE THIRD WORLD
By David D. Newsom

Indiana University Press; 256 pages; $29.95 and £22.95

Buy it at
Amazon.com
Amazon.co.uk

WHY does the United States have such troubled relations with so much of the third world? It is a good question, seldom asked by those who make American foreign policy, and even more seldom answered. In this book David Newsom, after a lifetime spent in the service of his country as ambassador to Libya, Indonesia and the Philippines, and later as under-secretary and assistant secretary of state, tries to make amends. He rightly points out that, if America is to find solutions to many of its foreign-policy problems, it will have to get to grips with the emotions, attitudes and disorder of the countries that started the 20th century as colonies of the West.

The subject is rich, not least because it involves so many puzzles. How could "George III's oppressed colony turn into an imperialist in its own right"? How could a country whose national ideology is born of the pursuit of freedom prop up so many thugs and dictators? Why does anti-Americanism coexist with a love of so many things American—from movies, jeans and hamburgers to the essential openness and freedom of American life? How could America become the world's dominant power and yet remain so ignorant about the peoples who smart at its domination? How could a country that did so much to create the United Nations manage to earn the hostility of so many of its members?

Mr Newsom's attempted explanation is a *tour d'horizon* of the colonial and post-colonial history of Africa, Asia and the Middle East, with glances at Latin America. It is a superficial account, drawn mostly, to judge by the footnotes, from reference books, though interspersed with a few anecdotes (and too many trivial mistakes). Educative it may be, but it neither reveals anything new nor does it properly explore the United States' most contentious activities in the third world: its interventions in Latin America and elsewhere, the prosecution of the cold war, the role of the CIA, the Vietnam war, its failures in the Middle East.

Perhaps more seriously, the account offers no coherent line of argument. It is largely a potted history, and when it is not it is often just a disappointment:

> Was there ever a real Soviet and Cuban threat to US interests in Africa? Was the US manipulation of events in the Congo and Angola ultimately in the interests of the United States and of the peoples of the region? If the United States had followed the lead of the African consensus would the outcome have been any different? Such questions cannot be fully answered.

In truth, by concentrating on one half of the story—the third world—Mr Newsom was bound to fail, because many of the answers to his questions lie in America itself. He reports some of the symptoms: the share of the federal budget for international relations has fallen by half since 1980; America had economic sanctions against 70 countries in 1999; it gave proportionately less in aid to the world's poorest that year than in any year since records began; Congress refused to ratify the Comprehensive Test Ban Treaty, leaving it to moulder beside the 60-plus other treaties negotiated by one administration or another but unratified by the Senate. But what so turned Americans against the third world? Few answers here.

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Great philosophers

Meet Mr Green

May 3rd 2001
From The Economist print edition

IMMANUEL KANT (1724-1804) never set foot outside his native East Prussia. For all but a few years of his long, uneventful life he lived and taught in the Baltic port of Königsberg. Yet no philosopher since Aristotle has exercised such influence. Kant's thought transformed how the modern world approached enduring problems in metaphysics, epistemology, ethics and aesthetics. "The Critique of Pure Reason" ranks among the most important works of philosophy ever written; it is still one of the most difficult. Lord Macaulay, a great English historian, was exasperated to discover that he could not understand a word of it.

KANT: A BIOGRAPHY
By Manfred Kuehn

Cambridge University Press; 566 pages; $34.95 and £24.95

Buy it at
Amazon.com
Amazon.co.uk

Kant was one of the first thinkers to concentrate on philosophy alone, and the difficulty of his writing arises partly from a deliberate attempt to professionalise the subject and give it the rigour of experimental science. Yet his true originality went far deeper. Kant sought to reconcile two dominant but conflicting traditions: the rationalism of Descartes and the sceptical empiricism of Hume. Our experience of the outside world is never bare, Kant argued, but comes, as it were, ready clothed in thought; yet thought about an objective world is itself necessarily limited by the range of possible experience. The result, if true, was to throw humanity back on its own cognitive resources. God, the soul, immortality became hypotheses, things in themselves were inaccessible to human perception, and certainty was possible only within the limits dictated by the apparatus of human thought. The entire structure of metaphysics and theology seemed to totter under the rigour of Kantian criticism. Even though his intention had not been to subvert religion or the state, he was dubbed *der Alleszermalmer*, the "all-crusher". Yet the instrument of his critical philosophy was not the blunt hammer of a Nordic god, but the clarifying precision of systematic thought.

That precision is famously reflected in the folk memory of the philosopher, partly based on early biographers who knew him only in old age, which depicts him as a pedantic, solitary, slightly absurd bachelor whose entire life was run according to inflexible rules and whose habits were as regular as clockwork. This "machine man" derives from the popular image of Kantian ethics, which is founded on the metaphysical concept of the categorical imperative. Formulations of this moral principle vary. Sometimes Kant says: "Act as if your maxims were to serve at the same time as a universal law." Alternatively he emphasises the importance of treating others "always at the same time as an end, never merely as a means." The categorical imperative was easily vulgarised: into a duty to humanity in general rather than to anybody in particular, and more sinisterly into the elevation of race, class or any other collective above the individual. Kant's most famous passage evokes "the starry heavens above me and the moral law within me", the existence of which, unlike that of God, is not conjectural. Though a man of the Enlightenment, Kant also believed, however, that humanity had a natural propensity to "radical evil".

Manfred Kuehn's excellent new life is the first substantial biography of Kant since Germany's historical catastrophe, and the figure who emerges is not the familiar caricature of a withdrawn Prussian professor. The young Kant overcame his humble origins to become an elegant man-about-town. Oddly, Mr Kuehn glosses over the fact, evident from his portraits, that Kant was pigeon-breasted and slightly hunchbacked. His gregariousness is thus all the more striking, and Mr Kuehn goes so far as to say that conversational dialogue was of decisive importance to his thought: "His critical philosophy," he writes, "is an expression of this form of life."

Indeed, it is fascinating to learn from Mr Kuehn's account how large a debt Kant owed to his daily talks with a scholarly English merchant, Joseph Green, of Green, Motherby & Co. It was under Green's influence that the dandy developed into the ascetic, devoted to duty and with a missionary zeal to rescue philosophy from the entropy of scepticism. Green it was who spent every afternoon conversing with Kant until seven o'clock sharp (neighbours set their watches by the moment at which the professor emerged from their conclave), Green who shared his hero-worship of Hume and Rousseau, Green who showed Kant how to live his life according to strictly applied maxims, Green who guided Kant's modest investments, Green with whom he often dozed off as they smoked their pipes together. "Green's effect on Kant cannot be overestimated," concludes Mr Kuehn.

So the greatest German philosopher was also, we learn, a great Anglophile. He was, in this respect, not untypical of Frederick the Great's Prussia, and especially of the Hanseatic ports. The combination of English commerce and German intellect was evidently unbeatable. During the years of Anglo-German enmity, Joseph Green was forgotten. Today, it would be a splendid gesture for the many German firms in London to commemorate the unknown Englishman who helped Kant to greatness and thereby made Germany a home of philosophy for the next two centuries.

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The ins and outs of Europe

May 3rd 2001
From The Economist print edition

Openly or not, Europe will be a big issue in Britain's election campaign. We examine five short books laying out arguments for and against

JEAN MONNET, a founder of the European Union, often talked about British exceptionalism. The only way for fellow Europeans to deal with it, he would say with his characteristic tact, was to confront the British with facts so clear and compelling as to virtually dictate the European course to be followed. These five books aim to help people make up their own minds on how far "the facts" really do dictate the closer integration of Britain into the EU and, in particular, the abandonment of sterling for a fledgling common currency.

IS BETTER late than never the right answer once again with the euro? Anthony Browne reaches no clear conclusion. But he provides lucid, jargon-free summaries of the answers of the pro- and anti- camps to such commonly asked questions as: "Wouldn't it mean surrendering our sovereignty?" and "Isn't the British economy doing fine on its own, and won't it thrive outside?" In presenting the opposing views, Mr Browne, an economics journalist, draws freely on the pamphlets of the two main lobby groups, Britain in Europe and Business for Sterling, a debt he acknowledges. He keeps his own views on the euro to himself but rejects the criticism of Britain for fence-sitting. "That isn't a reflection of British indecisiveness," he says, "but of the little appreciated fact that in many ways the decision is far more difficult—and far more balanced—for Britain than it is for other European countries."

THE EURO: SHOULD BRITAIN JOIN?
By Anthony Browne

Icon Books; 126 pages; £3.99

Buy it at
Amazon.co.uk

THE UK AND THE EURO
By Paul Templeton

John Wiley; 141 pages; £16.99

Buy it at
Amazon.co.uk

The chief difference between Mr Browne's book and Paul Templeton's "The UK and the Euro" is price: Mr Templeton's is more than four times dearer. His publishers, Wiley, say they will bring out a paperback, but can't say when. Mr Templeton, for all that, gives value. There are many charts and tables. His 15 chapters include brief (and briefer) histories of sterling and the euro, a broad discussion of the pros and cons of joining, as well as a look at specific issues such as the existence of "right" exchange rates, the operation of central banks, the EU's tests for euro entry, the consequences of not joining and the possibility, once in, of getting out.

JOHN PINDER also strives for even-handedness in "The European Union". But as a professor at the College of Europe and president of the European Union of Federalists, Mr Pinder is hardly neutral. The illustrations he has chosen give him away, especially a photograph of Bill Clinton and Jacques Delors with the equipollent caption, "Two presidents meet".

Committed as he is, Mr Pinder is nevertheless scrupulous with the facts and his treatment of the arguments. His examination of EU institutions and policies will revive memories some veterans of Britain's 1975 membership referendum would prefer to forget. Mercifully, sluicegate prices and guaranteed access for New Zealand butter are no longer contentious issues, but such arcana as generalised preferences, own-resources budgeting and structural funds still demand the detailed attention they receive from Mr Pinder.

THE EUROPEAN UNION: A VERY SHORT INTRODUCTION
By John Pinder

Oxford University Press; 220 pages; $8.95 and £5.99

Buy it at
Amazon.com
Amazon.co.uk

THIS book aims not for neutrality but for controversy, not to say polemic. Just about everybody who is anybody in Britain in the debate on Europe has contributed an essay. They range from Europhobes such as Christopher Booker, John Redwood and Conrad Black to Europhiles like John Pinder and John Gummer. Each author sounds off on a pet subject, including the single currency, culture and identity, and the social agenda.

BRITAIN AND EUROPE: THE CHOICES WE FACE
Edited by Martin Rosenbaum

Oxford University Press; 310 pages; £8.99

Buy it at Amazon.co.uk

The clash of so many firmly held and strongly argued opinions may well leave readers more dazed than enlightened. Nonetheless, a few of the essays stick in the mind. In “The diplomacy of the heart”, Michael Elliott, a former editor of *Newsweek International*, asks the question, “Where do you telephone on Christmas day?” For the British, he says, the answer is not Europe. Rather, he claims, they call Uncle Harry or Aunt Flo in San Diego or Sydney, or a son or daughter taking a gap year in Auckland or Oregon. Is this still true? Perhaps less than Mr Elliott imagines. But the question is a good one, underlining that Europe is not purely an economic issue.

Lord Owen’s contribution is measured—and thought-provoking: broadly in favour of a European Rapid Reaction Force but doubtful whether it can work. An essay on the euro, “The political case for joining” by an ex-diplomat, Dame Pauline Neville-Jones, shows off that dry, analytical intelligence for which the Foreign Office is, or used to be, famous.

BLAIR’S BRITAIN, ENGLAND’S EUROPE: A VIEW FROM IRELAND.
Edited by Paul Gillespie.
Institute of European Affairs; 326 pages; IR£15 and 19 euros

THE final book provides a valuable non-British perspective. Its title is making a point. “Britain’s problem with Europe”, says the book’s introduction, “is essentially an English one. Neither the Scots nor the Welsh suffer from the identity crisis manifest in the tortured relationship of the English with their fellow Europeans.” The contributors are Irish politicians, journalists, academics and industrialists who keep a weather eye on their large neighbour. As they see it, uncertainty about the outlook is caused not by Britain but by an England confronted simultaneously by pressure to devolve sovereignty to the Celtic nations and pressure to share it externally with other nation states in Europe.

Against this background the authors explore various ways England’s crisis of identity might resolve itself. They are in no doubt which one they prefer: Labour wins re-election, Britain devolves, shares sovereignty and takes a positive role in the leadership of Europe. Were Jean Monnet alive to see it, he would applaud this outcome—but it would not in the least surprise him.

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New fiction (1)

A lot on her plate

May 3rd 2001
From The Economist print edition

THE photography of Julia Margaret Cameron is the inspiration behind this lyrical novel set in the 1860s. It tells the story of Annie Phelan, an Irish maid, and her relationship with her employers. A secret reader, Annie has devoured Charlotte Brontë's "Jane Eyre" and anticipates emotional complications when she arrives to take up a new post at a country house. She ends up at the centre of a tense and ambiguous love triangle. Annie's mistress, the demanding Isabelle Dashell, is a photographer who, like Cameron, puts her servants in fancy dress and uses them as models. Annie is not only beautiful; her histrionic gifts make her equally convincing as Guinevere or the Virgin Mary, and she is soon not merely posing for pictures but established as a favoured muse.

AFTERIMAGE
By Helen Humphreys

Metropolitan Books; 240 pages; $23.
Bloomsbury; £15.99 (Ã‚£6.99 paperback)

Buy it at
Amazon.com
Amazon.co.uk

In the relationship that develops, the hierarchies of servant and mistress, artist and model begin to break down. Simultaneously, Annie gets close to Isabelle's husband, Eldon, a frustrated armchair cartographer who lets her into his fantasy world of polar exploration. With Annie torn between mistress and master, it becomes harder and harder to see who is manipulating whom, and the story can only end (like "Jane Eyre") in a symbolic conflagration.

As an artist, Isabelle is a perfectionist. Her creator, Helen Humphreys (the author of one previous novel, "Leaving Earth"), is equally concerned with detail: her every word is carefully weighed. In her limpid, elastic prose the business of creating photographs is turned into poetry. The chemical preparations, the fall of light on drapery, the expressions on the models' faces and the mysteries of photographic plates and darkrooms take on an almost sacramental intensity. As a result, the Isabelle sections are more gripping than those involving her enervated husband. Indeed, the visual is so important in this book that the descriptive writing has more emotional charge than the passages which give us access to the main characters' minds.

If the dialogue sometimes sounds a little modern, no matter. Julia Margaret Cameron's medieval vision was seen through a Victorian lens, and Ms Humphreys is, similarly, right not to mimic the style of the 19th-century novel. Very much a work of art rather than of history, this beautifully written novel edges towards saying something profound about the relationships between art and life, men and women, the powerful and the disempowered, without ever becoming a simplistic parable.

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Julia Margaret Cameron

May 3rd 2001
From The Economist print edition

The work of Julia Margaret Cameron (1815-79) is among the first of the Phaidon 55s, a beautiful series of pocketbooks (Phaidon Press; £4.95) with 55 photographs each by the world's most famous photographers.

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New fiction (2)

Prairie passions

May 3rd 2001
From The Economist print edition

LOUISE ERDRICH is the author of seven highly acclaimed novels, including “Love Medicine” and “Tracks”, as well as two collections of poetry. She is probably the most famous Native American writer alive; much of her fiction is set in North Dakota, where she grew up, and deals with aspects of Indian experience.

THE LAST REPORT ON THE MIRACLES AT LITTLE NO HORSE
By Louise Erdrich

HarperCollins; 362 pages; $26 and £25

Buy it at
Amazon.com
Amazon.co.uk

Her new novel, “The Last Report on the Miracles at Little No Horse”, starts with a splendid leap into the unfamiliar. It is 1910. Agnes DeWitt, a young Swabian nun living on a barren reach of North Dakota, discovers, on the convent piano, a sensuous love for Chopin. Once out of the convent she discovers a similar passion for sex, and the novel changes tone. She is kidnapped in a bank robbery and her beau is killed while trying to save her. A great flood then washes her into Indian country. Agnes fetches up on a river bank beside the corpse of Father Damien Modeste, a priest drowned on his way to an Ojibwe mission. She takes Father Damien’s cassock and his name and, thus disguised, serves as priest and confessor to the Little No Horse reservation until her (that is his?) death. This deception is, she maintains, “the most sincere lie a person could ever tell”. The story takes shape in letters to the Vatican under the name of Father Damien, concerning supposed miracles at Little No Horse.

Ms Erdrich’s language is crystalline, and there are wonderful passages on the double identity of Agnes and the priest, who acknowledge each other only in private prayer. It is doubly disappointing, then, that, once at Little No Horse, the story falls flat. The parishioners’ feuding is so hard to follow that readers may give up before the moving description of what proves to be Father Damien’s own moral trial.

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And still the crowds come

May 3rd 2001
From The Economist print edition

THE first thing to notice about the ten most-visited exhibitions of 2000 is the absence of Impressionist shows. This is probably why the highest daily attendance last year is so well below the chart-busting 8,597 for the Monet show at London's Royal Academy in 1999. But strip out that exception, and the daily averages are healthily up on or in line with 1999 and 1998. No sign, in other words, of a drop in public demand to see fine art.

Worth queuing for
Top ten museum exhibitions in 2000, attendance

Exhibition	Venue	Daily	Total
El Greco: Identity and Transformation	National Gallery, Athens	6,843	629,572
Earthly Art, Heavenly Beauty	State Hermitage, St Petersburg	5,876*	570,000*
Sinai: Byzantium, Russia	State Hermitage, St Petersburg	5,495*	500,000*
Seeing Salvation	National Gallery, London	5,002	355,175
Picasso's World of Children	National Museum of Western Art, Tokyo	4,290	386,086
Rembrandt and Vermeer	National Museum of Western Art, Tokyo	3,892	280,259
Amazons of the Avant-Garde	Guggenheim Museum, Bilbao	3,879	283,181
The Glory of the Golden Age	Rijksmuseum, Amsterdam	3,808	594,122
Van Gogh: Face to Face	Museum of Fine Arts, Boston	3,762	316,049
Van Gogh: Face to Face	Detroit Institute of Arts, Detroit	3,706*	315,000*

Source: *The Art Newspaper* *Estimate

And old master, in this context, did not necessarily mean old standard. "El Greco: Identity and Transformation" was a smash-hit in Greece. St Petersburg's Hermitage surveyed Islamic art, including more than a hundred versions of the Koran. "Seeing Salvation" at London's National Gallery, which traced representations of Christ, was a surprise success. Japanese art lovers flocked to "Picasso's World of Children". Tokyo's National Museum of Western Art released exhibition attendance statistics for the first time in 2000, and the figures are impressive—all the more so with an average ticket price of $11 (£8.50). Who said only painters have to suffer for their art?

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Richard Schultes

May 3rd 2001
From The Economist print edition

Richard Evans Schultes, jungle botanist, died on April 10th, aged 86

IN AN account by Richard Schultes of his experiences among the Indians of southern Mexico he described a mushroom, previously unknown outside the region, used to create hallucinations. The account was mainly academic in style; nevertheless it excited a writer who went to the region and sampled the mushroom. His report was published in *Life* magazine in 1957 under the title "Seeking the Magic Mushrooms". Thus the "magic mushroom" came to the United States, to be promoted among others by Timothy Leary, one of the high priests of American drug culture of the 1960s, and still remembered for his recipe for supine living, "Turn on, tune in, drop out".

The Linnean Society of London

Although Mr Schultes never expected his botanical discoveries to affect, however indirectly, American social behaviour, he did not criticise Leary and his weird followers for their use of drugs. He merely expressed his disappointment that Leary had not spelt correctly the Latin names of plants from which their drugs were derived.

But Mr Schultes was sad that the public attention given to their hallucinogenic effects distracted from the value of plants as a source of medicines. After his adventure in Mexico he spent many years among tribespeople along the Amazon river. He collected thousands of previously unrecorded plants and reckoned that some 2,000 had medical value. Many more, he believed, were waiting in the jungle to benefit humanity. He liked to talk about curare. For many years it had been known as a powerful, but short-term, poison on darts and arrows used by Amazonian natives. Mr Schultes traced the plants that curare came from. They yielded a substance now used as a muscle relaxant in surgery.

He inevitably became concerned that the Amazonian jungle and its inhabitants were disappearing alarmingly quickly. Around 100 tribes have become extinct in Brazil alone in the past few decades. As the tribespeople disappear, so does their knowledge. Mr Schultes saw it as his job "to salvage some of the native medico-botanical lore" before it was lost. Perhaps, he said, the cure for cancer "may come from the witch-doctor's knowledge of plants".

His orchid

Richard Schultes's parents were immigrants from Germany. His father was a plumber in Boston. Young Richard won a scholarship to Harvard, the first member of his family to go to university. In 1941 "as a young botanist, armed with a bright, new doctor's degree", as Mr Schultes described himself, he was sent by Harvard on a trip to the Amazon to study medicinal, narcotic and poisonous plants. On his first day in the jungle he found a previously unrecorded orchid. He sent it back to Harvard where it was called *Pachyphllum schultesii*, the first of many plants attached to his name. He was due to return after a few months but stayed in Amazonia for 14 years. During the second world war he was told to remain in the jungle to look for sources of natural rubber for the United States to replace Asian plantations lost to the Japanese.

Mr Schultes sought to travel simply. His kit is a reproach to overloaded backpackers. He carried a single change of clothing, and little food: he ate the same as his native hosts. He did have a canoe, but it was light enough to carry unaided, and anyway the natives were usually happy to lend a hand. Heavy boots, he found, were usually unnecessary because jungle snakes generally struck at the neck. A pith helmet, though, he found indispensable in the rainforest. This made Mr Schultes resemble an explorer of the Victorian era, which in some ways he was. One of his heroes was Richard Spruce, a 19th-century British naturalist who also explored the Amazon region.

Like the Victorians, Mr Schultes had an unquenchable curiosity that went beyond his speciality. He wrote

about the use of hallucinogens in tribespeople's religious ceremonies. Shamans, medical men, under the influence of hallucinogens believed that they acquired supernatural powers enabling them to cure illness, locate lost articles, affect fertility and control the weather. Mr Schultes saw a connection with stories of European witches who used potions that enabled them to fly. "Flying" was an experience claimed by some of Leary's followers. Mr Schultes's Christianity seems to have remained untouched, but he accepted that to Indians throughout the Americas some plants are sacred. One of his books is called "Where the Gods Reign".

Back from the Amazon with extraordinary tales to tell, Richard Schultes remained at Harvard as a teacher until he retired in his 70s. Students remember his prowess with a blowpipe that he kept in his laboratory. Each year he returned to the Amazon to collect more plants. He received numerous honours. A chunk of Amazonia preserved by the Colombian government is called Sector Schultes. He edited a journal called *Economic Botany*, covering a science of which he was a pioneer. Mr Schultes remained a modest man. A reporter, awed by his reputation as the world's top authority on ethnobotany, asked how he should be described. "Just a jungle botanist," said Richard Schultes.

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OUTPUT, DEMAND AND JOBS

May 3rd 2001
From The Economist print edition

Growth in American GDP picked up to an annual rate of 2.0% in the first quarter, double most forecasts. Britain's first-quarter growth was slower than expected: GDP rose by only 0.3% over the previous quarter, the smallest quarterly increase since the end of 1998. In the year to March, industrial production in Japan fell by 2.9%.

% change at annual rate	GDP		The Economist poll GDP forecasts		Industrial production		Retail sales (volume)	Unemployment % rate	
	3 mths†	1 year	2001	2002	3 mths†	1 year	1 year	latest	year ago
Australia	− 2.2	+ 2.1 Q4	+ 2.1	+ 4.0	+ 0.8	+ 3.1 Q4*	− 0.1 Q4	6.8 Mar	6.8
Austria	+ 1.7	+ 2.6 Q4	+ 2.2	+ 2.5	na	+ 7.0 Feb*	+ 4.9 Jan	3.7 Feb	3.6
Belgium	+ 4.9	+ 3.1 Q4	+ 2.6	+ 2.6	na	+ 3.8 Feb*	− 2.8 Feb	10.3 Mar*	10.6
Britain	+ 1.4	+ 2.5 Q1	+ 2.3	+ 2.8	− 2.6	+ 1.0 Feb	+ 4.8 Mar	5.2 Feb‡	5.8
Canada	+ 2.6	+ 4.0 Q4	+ 2.1	+ 3.2	− 3.1	+ 1.5 Feb	+ 3.9 Jan	7.0 Mar	6.8
Denmark	+ 4.9	+ 1.1 Q4	+ 1.9	+ 2.2	na	+ 5.2 Feb	− 0.6 Feb	5.4 Feb	5.3
France	+ 3.9	+ 2.8 Q4	+ 2.6	+ 2.7	+ 2.1	+ 2.4 Feb	+ 0.1 Feb	8.7 Mar	10.0
Germany	+ 0.8	+ 1.9 Q4	+ 1.9	+ 2.5	+ 7.4	+ 4.7 Feb	− 6.7 Feb	9.3 Mar	10.1
Italy	+ 3.2	+ 2.7 Q4	+ 2.2	+ 2.4	+ 5.3	− 1.5 Feb	− 0.5 Feb	9.9 Jan	11.2
Japan	+ 3.0	+ 2.8 Q4	+ 0.6	+ 1.3	−13.7	− 2.9 Mar	+ 1.8 Jan	4.7 Mar	4.8
Netherlands	+ 3.8	+ 2.8 Q4	+ 2.8	+ 2.9	+ 2.5	+ 1.9 Feb	+ 2.5 Jan	2.2 Mar§	2.9
Spain	+ 2.9	+ 3.7 Q4	+ 2.8	+ 3.1	− 1.2	− 3.5 Feb	na	13.7 Feb	15.0
Sweden	+ 2.4	+ 2.6 Q4	+ 2.6	+ 2.9	na	+ 6.2 Feb	+ 4.9 Jan	3.9 Mar*	5.1
Switzerland	+ 1.8	+ 2.5 Q4	+ 1.9	+ 2.2	na	+ 5.0 Q4*	+ 4.9 Jan	1.8 Mar*	2.3
United States	+ 2.0	+ 2.7 Q1	+ 1.5	+ 3.0	− 4.7	+ 0.8 Mar	+ 1.5 Feb	4.3 Mar	4.0
Euro area	+ 2.8	+ 3.0 Q4	+ 2.3	+ 2.6	+ 5.3	+ 3.8 Feb	+ 2.3 Jan	8.7 Feb	9.4
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*								
Finland	+ 3.0	+ 5.5 Q4	na	na	− 8.1	+ 6.8 Feb	+ 3.8 Jan	9.6 Mar*	11.2
Greece	na	+ 2.5 2000	na	na	na	+ 3.1 Nov	+ 6.0 Nov	na	na
Iceland	na	+ 4.4 1999	na	na	na	+ 4.2 1999	na	1.3 Jan	1.5
Ireland	na	+11.0 Q3	na	na	na	+34.1 Feb*	+ 4.6 Jan	3.6 Mar	4.3
Luxembourg	na	+ 8.5 2000	na	na	na	+ 0.6 Dec*	+ 9.4 Nov	2.8 Jan	2.6
New Zealand	+ 2.2	+ 1.6 Q4	na	na	na	+ 0.9 Q4*	+ 7.3 Q4	5.6 Q4	6.3
Norway	+ 0.2	+ 0.9 Q4	na	na	− 5.4	− 0.9 Feb	− 2.4 Feb	3.1 Q4	3.2
Portugal	+ 5.1	+ 3.4 Q3	na	na	na	+ 3.6 Feb*	+ 4.6 Jan	3.8 Q4	4.1

*Not seasonally adjusted. †Average of latest 3 months compared with average of previous 3 months, at annual rate. ‡Dec-Feb; claimant count rate 3.3% in March. §Jan-Mar.

Text refers only to the first 16 countries listed

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COMMODITY PRICE INDEX

May 3rd 2001
From The Economist print edition

Sugar prices rose 8% this week, on rumours that China may have bought up to 500,000 tonnes on the world market. China's sugar production has fallen by a third since the 1999-2000 season, when a big freeze damaged the crop; output this season is about 6m tonnes. Even though China has been selling off its stockpile, C. Czarnikow, a firm of traders, says it may need to import 1.5m tonnes of sugar this year—twice as much as in 2000. Sugar consumption in China has levelled off in recent years. Cheaper saccharin has filled the gap in demand for sweeteners. The government aims to cut output of saccharin, but high sugar prices have led to more substitution. China's soft-drinks and food industry used 4.5m tonnes of sugar last year.

1995=100	Apr 24th	May 1st*	% change on one month	% change on one year
Dollar index				
All items	69.7	70.8	+ 3.9	– 5.6
Food	66.8	68.2	+ 1.4	– 7.6
Industrials				
All	73.6	74.3	+ 7.1	– 3.1
Nfa†	72.2	72.0	+ 10.5	– 1.5
Metals	74.8	76.2	+ 4.6	– 4.4
Sterling index				
All items	76.5	77.9	+ 3.5	+ 2.9
Food	73.3	75.1	+ 1.0	+ 0.8
Industrials	80.8	81.8	+ 6.7	+ 5.6
Euro index				
All items	102.5	104.5	+ 3.3	– 3.9
Food	98.2	100.7	+ 0.9	– 5.8
Industrials	108.3	109.6	+ 6.6	– 1.3
Yen index				
All items	90.6	92.0	+ 0.7	+ 5.8
Food	86.8	88.6	– 1.7	+ 3.6
Industrials	95.7	96.5	+ 3.8	+ 8.6
Gold				
$ per oz	263.45	263.95	+ 2.6	– 3.9
Crude oil North Sea Brent				
$ per barrel	25.69	28.21	+ 14.6	+ 11.8
West Texas Intermediate				
$ per barrel	26.88	28.35	+ 6.5	+ 5.7

* Provisional. † Non-food agriculturals.

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ECONOMIC FORECASTS

May 3rd 2001
From The Economist print edition

Every month *The Economist* surveys a group of economic forecasters and calculates the average of their predictions for economic growth, inflation and current-account balances for 15 countries and for the euro area. The table also shows the highest and lowest forecasts of growth. The previous month's forecasts, where different, are shown in brackets. This month our panel has again lowered its average predictions for growth in the euro area, in both 2001 and 2002. German GDP is now expected to expand by only 1.9% this year, down from the 2.4% rate forecast two months ago. The prediction for growth in Britain in 2001 has also fallen slightly, to 2.3%. For the first time this year, the panel has raised its forecast for American growth in 2001—albeit modestly, from 1.4% to 1.5%.

The Economist poll of forecasters, May averages (previous month's, if changed)

	Real GDP, % change Low/high range		Real GDP, % change average		Consumer prices % increase		Current account % of GDP	
	2001	2002	2001	2002	2001	2002	2001	2002
Australia	1.3/3.1	3.3/5.2	2.1 (2.3)	4.0 (3.9)	3.6 (3.5)	2.3	–2.9(–3.0)	–3.2
Austria	1.8/2.9	1.6/2.9	2.2 (2.3)	2.5	1.8	1.4	–2.5(–2.4)	–2.0(–1.9)
Belgium	2.3/3.1	2.0/3.1	2.6	2.6 (2.7)	1.9	1.7 (1.8)	4.2 (4.0)	4.3 (4.0)
Britain	1.9/2.6	2.2/3.3	2.3 (2.4)	2.8 (2.7)	1.9 (2.0)	2.3	–2.1(–2.0)	–2.0(–1.9)
Canada	1.0/3.2	2.0/4.2	2.1 (2.2)	3.2 (3.3)	2.3	2.1 (2.0)	1.2 (1.1)	1.0 (0.9)
Denmark	1.5/2.4	1.7/3.0	1.9	2.2	2.2 (2.3)	2.2	1.4	1.4
France	2.4/2.8	2.3/3.1	2.6	2.7	1.3 (1.4)	1.4	1.6 (1.9)	1.6 (1.8)
Germany	1.7/2.0	2.0/2.9	1.9 (2.1)	2.5 (2.6)	2.0 (1.8)	1.4 (1.3)	–1.4(–1.3)	–1.1
Italy	1.8/2.5	1.5/2.8	2.2	2.4 (2.5)	2.4 (2.3)	1.9	–0.3	nil
Japan	–0.5/1.5	0.4/2.7	0.6 (0.5)	1.3	–0.4 (–0.5)	–0.3	2.2	2.2
Netherlands	2.5/3.3	2.2/4.0	2.8 (2.9)	2.9 (3.1)	3.9 (3.6)	2.2 (2.3)	4.1 (3.9)	4.0 (3.9)
Spain	2.4/3.3	2.3/4.0	2.8 (3.0)	3.1 (3.3)	3.1 (3.0)	2.6 (2.4)	–2.9	–2.6
Sweden	2.0/3.0	2.2/3.8	2.6 (2.7)	2.9 (3.0)	1.7 (1.6)	1.7	2.3 (2.1)	2.2 (2.1)
Switzerland	1.6/2.5	1.5/2.8	1.9 (2.0)	2.2	1.2	1.2 (1.3)	11.8	11.4(11.2)
United States	0.0/2.2	1.5/3.8	1.5 (1.4)	3.0	2.9 (2.8)	2.3 (2.2)	–4.3	–4.0(–4.1)
Euro area	2.2/2.6	2.1/3.1	2.3 (2.4)	2.6 (2.7)	2.1 (2.0)	1.6	–0.3 (–0.2)	–0.1

Sources: ABN Amro, Deutsche Bank, EIU, Goldman Sachs, HSBC Securities, KBC Bank, Merrill Lynch, J.P. Morgan,Morgan Stanley Dean Witter, Nordbanken, Decision Economics, Royal Bank of Canada, Salomon Smith Barney, Scotiabank, Shinsei Bank, Warburg Dillon Read.

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PRICES AND WAGES

May 3rd 2001
From The Economist print edition

In April, annual consumer-price inflation in Germany hit 2.8%, the fastest since August 1994; and Italian prices, clocking their fastest increase for nearly five years, rose by 3.1%. Japanese consumer prices fell by 0.4% in the year to March. Over the same period French producer-price inflation slowed to 2.8%.

% change at annual rate	Consumer prices*		The Economist poll consumer prices forecast		Producer prices*		Wages/earnings	
	3 mths†	1 year	2001	2002	3 mths†	1 year	3 mths†	1 year
Australia	+ 4.3	+ 6.0 Q1	+ 3.6	+ 2.3	– 4.9	+ 5.2 Q1	– 2.8	+ 5.1 Q4
Austria	na	+ 2.7 Mar	+ 1.8	+ 1.4	– 0.2	+ 2.7 Mar	+ 5.4	+ 2.6 Feb
Belgium	+ 2.9	+ 2.8 Apr	+ 1.9	+ 1.7	– 9.9	+ 4.3 Feb	+ 3.7	+ 1.6 Q4
Britain	– 0.5	+ 2.3 Mar	+ 1.9	+ 2.3	– 2.7	+ 0.8 Mar	+10.5	+ 5.0 Feb
Canada	+ 1.7	+ 2.5 Mar	+ 2.3	+ 2.1	– 0.5	+ 2.4 mar	+ 0.5	+ 0.2 Jan‡
Denmark	+ 1.7	+ 2.3 Mar	+ 2.2	+ 2.2	– 2.2	+ 3.0 Mar	+ 3.7	+ 3.8 Q4
France	– 0.1	+ 1.3 Mar	+ 1.3	+ 1.4	– 2.9	+ 2.8 Mar	+ 2.6	+ 5.0 Q4
Germany	+ 4.6	+ 2.8 Apr	+ 2.0	+ 1.4	– 0.1	+ 3.3 Mar	na	+ 2.4 Feb*
Italy	+ 3.5	+ 3.1 Apr	+ 2.4	+ 1.9	+ 0.6	+ 4.1 Mar	+ 1.2	+ 2.0 Feb*
Japan	– 1.2	– 0.4 Mar	– 0.4	– 0.3	+ 2.5	+ 1.1 Mar	na	+ 0.9 Feb
Netherlands	+ 6.9	+ 4.6 Mar	+ 3.9	+ 2.2	– 0.9	+ 5.3 Feb	+ 2.7	+ 2.9 Mar
Spain	+ 2.9	+ 3.9 Mar	+ 3.1	+ 2.6	– 0.6	+ 3.6 Feb	+ 1.9	+ 2.2 Q4
Sweden	na	+ 1.9 Mar	+ 1.7	+ 1.7	– 1.5	+ 2.6 Mar	+ 3.2	+ 1.5 Feb*
Switzerland	– 0.1	+ 1.2 Apr	+ 1.2	+ 1.2	– 3.0	+ 0.5 Mar	na	+ 0.2 1999
United States	+ 4.2	+ 2.9 Mar	+ 2.9	+ 2.3	+ 5.7	+ 3.1 Mar	+ 4.3	+ 4.3 Mar
Euro area	+ 2.3	+ 2.6 Mar	+ 2.1	+ 1.6	– 0.2	+ 4.4 Feb	+ 2.4	+ 2.4 Q4
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Finland	+ 0.7	+ 2.9 Mar	na	na	– 7.6	+ 3.2 Mar	+ 3.0	+ 4.3 Q4*
Greece	– 2.7	+ 3.0 Mar	na	na	– 4.3	+ 4.8 Feb	na	na
Iceland	+ 4.5	+ 4.5 Apr	na	na	+11.1	+ 4.2 April	+16.8	+ 9.2 Mar
Ireland	+ 0.9	+ 5.4 Mar	na	na	– 2.5	+ 3.1 Mar	+ 4.7	+ 7.4 Q3*
Luxembourg	– 0.1	+ 2.9 Mar	na	na	+ 2.5	+ 4.2 Feb	+ 7.7	+ 8.4 Oct*
New Zealand	– 0.8	+ 3.1 Q1	na	na	+15.0	+10.2 Q4	+ 1.8	+ 1.6 Q4
Norway	+ 6.1	+ 3.7 Mar	na	na	na	– 0.1 Mar	+ 7.7	+ 4.3 Q4*
Portugal	+ 4.4	+ 5.1 Mar	na	na	– 9.5	+ 6.0 Feb	na	+ 1.6 Jan*

*Not seasonally adjusted. †Average of latest 3 months compared with average of previous 3 months, at annual rate. ‡New series.

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MONEY AND INTEREST RATES

May 3rd 2001
From The Economist print edition

Growth rates of both broad- and narrow-money supply in Australia continued to rise in March, to 14.1% and 7.5%, respectively. Danish money supply contracted again in March.

	Money supply* % rise on year ago			Interest rates % p.a. (May 2nd 2001)							
				over-	3-mth money market		banks	2-year	10-year gov't		corporate
	narrow	broad		night	latest	year ago	prime	gov't bonds	latest†	year ago	bonds
Australia	+14.1	+ 7.5	Mar	5.00	4.88	6.28	8.00	4.76	5.82	6.52	7.11
Britain	+ 8.3	+ 8.4	Mar	5.50	5.25	5.25	6.50	4.96	5.04	5.24	6.60
Canada	+12.9	+ 5.6	Mar	4.71	4.43	5.50	6.50	4.82	5.75	6.27	7.23
Denmark	– 2.2	– 6.5	Mar§	5.65	5.32	4.51	8.00	5.05	5.24	5.70	7.18
Japan	+ 5.0	+ 2.6	Mar	0.01	0.02	0.04	1.38	0.06	1.36	1.71	0.67
Sweden	+ 5.0	+ 1.4	Mar	4.10	4.01	4.03	4.66	4.38	5.07	5.50	5.28§
Switzerland	– 3.9	+ 1.1	Mar	3.19	3.19	3.20	5.13	3.11	3.45	4.02	4.23
United States	– 0.2	+ 9.8	Mar	4.50	4.17	6.57	7.50	4.05	5.29	6.39	7.17
Euro area‡	+ 1.8	+ 4.7	Feb	4.79§	4.78§	4.18	4.50§	4.58	4.95	5.34	5.70§

†France 5.04, Germany 4.89, Italy 5.38. Benchmarks: Japan No.229 1.34, US 30-yr 5.75. ‡Germany for prime and bonds. §April 25th.

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4.Sources: Commerzbank, Danske Bank, J.P. Morgan Chase, Royal Bank of Canada, OM Fixed Income Exchange, Warburg Dillon Read, WEFA Gp, Westpac, Thomson Financial Datastream.Rates cannot be construed as banks' offers.

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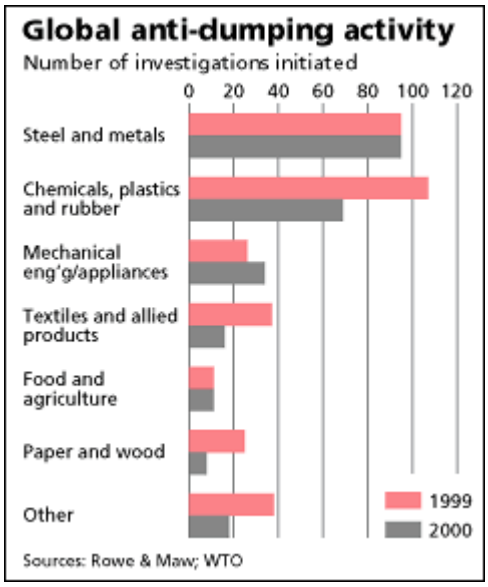
UNFAIR TRADE

May 3rd 2001
From The Economist print edition

The worldwide steel and metals industry was the subject of the biggest number of anti-dumping investigations initiated by members of the World Trade Organisation last year. A report by Rowe & Maw, a corporate-law firm, records 95 cases involving steel and metals—more than a third of the year's total. Of these cases, 37 were started by America, in an attempt to protect its ailing steel industry from foreign competition. The steel business has entered a period of restructuring amid a wave of consolidation by the world's biggest producers. Steel accounted for 80% of America's anti-dumping investigations in 2000, and American companies are clamouring for even more cases this year. In relative terms, the paper and wood industries showed the biggest drop in anti-dumping activity over the past year: 25 cases were begun in 1999, but just eight got going in 2000. Investigations involving textiles and related products also fell sharply, from 37 to 16.



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TRADE, EXCHANGE RATES AND BUDGETS

May 3rd 2001
From The Economist print edition

In February, the European Union's current account jumped into surplus for the first time in five months; the 12-month deficit shrank by nearly 10% compared with January. Hurt by weak data from purchasing managers, the euro shed 0.9% against the American dollar. But the greenback fell by 3.0% against the Australian dollar. In trade-weighted terms, the yen rose by 0.2%.

	Trade balance*, $bn		Current account		Exchange rate		Currency units				Budget
	latest month	latest 12 months	$bn latest 12 mths	The Economist poll % of GDP, forecast 2001	2002	trade-weighted† May 2nd	year ago	per $ May 2nd	year ago	per £	per euro	per ¥100	balance % of GDP 2000‡
Australia	+ 0.28 Feb	– 3.6	– 15.1 Q4	-2.9	-3.2	72.6	77.8	1.92	1.69	2.75	1.71	1.58	0.9
Austria	– 0.57 Jan§	– 4.6	– 4.7 Feb	-2.5	-2.0	100.3	99.1	15.4	15.4	22.1	13.8	12.6	-1.6
Belgium	+ 1.85 Feb§	+ 13.6	+ 11.6 Dec	4.2	4.3	98.9	97.3	45.2	45.2	64.9	40.3	37.1	-0.1
Britain	– 3.32 Feb	– 43.3	– 24.5 Q4	-2.1	-2.0	105.7	113.6	0.70	0.64	–	0.62	0.57	2.7
Canada	+ 3.86 Feb	+ 39.3	+ 12.7 Q4	1.2	1.0	78.5	79.9	1.53	1.49	2.19	1.37	1.26	2.5
Denmark	+ 0.34 Feb	+ 5.5	+ 3.6 Feb	1.4	1.4	101.8	98.8	8.37	8.36	12.0	7.46	6.86	2.7
France	+ 0.89 Feb	+ 1.2	+ 22.6 Jan	1.6	1.6	101.6	99.9	7.36	7.36	10.5	6.56	6.03	-1.4
Germany	+ 5.74 Feb§	+ 51.9	– 24.2 Feb	-1.4	-1.1	98.6	96.4	2.19	2.19	3.14	1.95	1.80	1.4
Italy	+ 0.71 Feb	+ 1.6	– 5.8 Jan	-0.3	nil	72.5	71.4	2,171	2,171	3,113	1,936	1,780	-0.1
Japan	+ 8.86 Feb§	+ 108.6	+ 112.1 Feb	2.2	2.2	138.3	153.0	122	109	175	109	–	-6.0
Netherlands	+ 1.88 Feb§	+ 16.0	+ 13.7 Q4	4.1	4.0	97.8	96.0	2.47	2.47	3.54	2.20	2.03	1.6
Spain	– 3.10 Jan	– 39.6	– 17.7 Dec	-2.9	-2.6	74.2	73.0	187	187	267	166	153	-0.3
Sweden	+ 1.07 Mar	+ 11.0	+ 5.1 Feb	2.3	2.2	76.5	85.1	10.25	9.05	14.7	9.14	8.40	3.4
Switzerland	+ 0.09 Mar§	– 0.5	+ 31.1 Q4	11.8	11.4	106.7	104.8	1.73	1.73	2.48	1.54	1.42	na
United States	– 33.35 Feb	– 453.9	– 434.9 Q4	-4.3	-4.0	118.5	112.5	–	–	1.43	0.89	0.82	2.3
Euro area	– 0.92 Feb	– 9.7	– 28.9 Feb	-0.3	-0.1	78.7	75.6	1.12	1.12	1.61	–	0.92	0.3
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*												
Finland	+ 0.77 Feb§	+ 13.1	+ 9.6 Feb	na	na	78.1	75.3	6.67	6.67	9.56	5.94	5.46	4.0
Greece	– 1.90 Q4	– 7.5	– 8.1 Dec	na	na	57.4	57.3	382	377	548	341	313	-1.0
Iceland	– 0.01 Feb§	– 0.5	– 0.9 Q4	na	na	na	na	100.0	76.3	143	89.1	81.9	2.8
Ireland	+ 2.55 Jan	+ 26.9	– 0.7 Q4	na	na	87.3	84.2	1.13	0.88	1.62	1.01	0.93	5.6
Luxembourg	– 0.15 Jan	– 2.4	+ 1.6 Q4	na	na	98.9	97.3	45.2	45.2	64.9	40.3	37.1	na
New Zealand	+ 0.03 Mar§	– 0.4	– 2.7 Q4	na	na	80.4	87.3	2.36	2.04	3.39	2.11	1.94	0.5
Norway	+ 2.08 Mar	+ 25.9	+ 22.5 Jan	na	na	94.5	91.1	9.07	9.05	13.0	8.09	7.44	14.0
Portugal	– 0.85 Jan§	– 14.7	– 10.4 Jan	na	na	89.3	87.8	225	225	322	200	184	-1.5

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †1990=100, Bank of England. ‡OECD estimate.
§Not seasonally adjusted.

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STOCKMARKETS

May 3rd 2001
From The Economist print edition

The Nasdaq Composite index rose by 7.8%, boosted by an unexpected first-quarter rebound in the American economy. Tokyo reached its highest level of the year after opinion polls showed firm support for Japan's new prime minister, Junichiro Koizumi.

Market indices	May 2nd	2001 high	2001 low	% change on one week	% change on one year	% change on record high	% change on Dec 31st 2000 in local currency	% change on Dec 31st 2000 in $ terms
Australia (All Ordinaries)	3,271.5	3,312.1	3,094.3	+ 0.9	+ 6.3	– 1.8	+ 3.7	– 2.9
Austria (ATX)	1,220.9	1,220.9	1,052.2	+ 1.8	+ 8.1	– 29.7	+ 13.7	+ 8.0
Belgium (Bel 20)	2,839.6	3,030.4	2,591.6	+ 1.0	+ 0.1	– 22.9	– 6.1	– 10.8
Britain (FTSE 100)	5,904.2	6,334.5	5,314.8	+ 1.3	– 4.5	– 14.8	– 5.1	– 8.9
Canada (Toronto Composite)	8,018.4	9,348.4	7,415.5	+ 0.9	– 13.7	– 29.6	– 10.2	– 12.0
Denmark (Copenhagen SE)	870.7	1,002.1	818.3	+ 1.0	– 0.5	– 16.2	– 4.0	– 8.8
France (SBF 250)	3,565.9	3,820.2	3,107.9	+ 3.1	– 12.4	– 18.8	– 5.4	– 10.2
Germany (Xetra DAX)	6,213.8	6,795.1	5,388.0	+ 1.6	– 15.8	– 23.0	– 3.4	– 8.3
Italy (BCI)	1,791.9	1,948.4	1,609.6	+ 2.2	– 10.5	– 17.9	– 6.5	– 11.2
Japan (Nikkei 225)	14,421.6	14,425.5	11,819.7	+ 4.3	– 21.8	– 62.9	+ 4.6	– 2.1
(Topix)	1,424.2	1,424.2	1,162.0	+ 6.2	– 16.3	– 50.6	+ 11.0	+ 3.9
Netherlands (EOE)	597.9	642.3	518.3	+ 3.8	– 10.7	– 14.8	– 6.2	– 10.9
Spain (Madrid SE)	924.6	963.9	818.6	+ 2.8	– 13.1	– 19.3	+ 5.0	– 0.3
Sweden (Affarsvarlden Gen)	251.6§	292.7§	217.2§	+ 5.3	– 96.0	– 37.1	– 9.3	– 16.5
Switzerland (Swiss Market)	7,369.9	8,135.4	6,574.0	+ 2.2	– 1.7	– 12.4	– 9.4	– 15.2
United States (DJIA)	10,876.7	10,983.6	9,389.5	+ 2.4	+ 3.8	– 7.2	+ 0.8	+ 0.8
(S&P 500)	1,267.4	1,373.7	1,103.3	+ 3.1	– 10.4	– 17.0	– 4.0	– 4.0
(Nasdaq Comp)	2,220.6	2,859.2	1,638.8	+ 7.8	– 40.1	– 56.0	– 10.1	– 10.1
Europe (FTSE Eurotop 300)*	1,448.6	1,545.5	1,279.0	+ 2.3	– 12.0	– 15.0	– 5.5	– 10.3
Euro area (FTSE Ebloc 100)*	1,320.6	1,404.1	1,143.9	+ 3.0	– 10.8	– 14.8	– 5.1	– 9.9
World (MSCI)†	1,153.8	1,249.2	1,014.6	+ 3.0	– 14.4	– 20.4	na	– 6.1
World bond market (Salomon)‡	432.1	447.8	427.5	– 0.3	+ 3.5	– 6.0	na	– 2.7

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in dollar terms.
‡Salomon Smith Barney World Government Bond Index, total return, in dollar terms. §Rebased.

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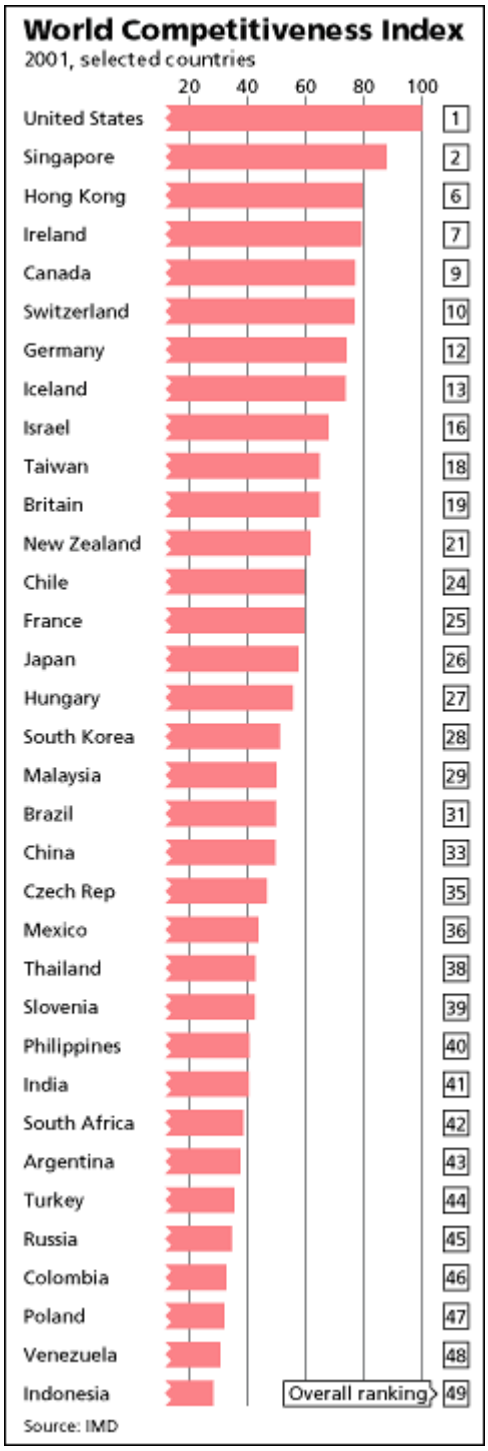
COMPETITIVENESS

May 3rd 2001
From The Economist print edition

Each year the International Institute for Management Development, a Swiss business school, assesses how countries are doing in terms of their business competitiveness. IMD ranks 49 countries according to 286 criteria, in four categories: economic performance, government efficiency, business efficiency and infrastructure. Some criteria are “hard” data, such as GDP. Others, such as executives’ beliefs about the availability of good managers, are “soft” data intended to capture perceptions. As in 2000, IMD believes that America is the best country at fostering competitiveness, followed by Singapore. After a strong economic performance last year, Hong Kong ranks third among the countries in our chart (and sixth of all 49), up from eighth (and 12th overall) in 2000.



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FINANCIAL MARKETS

May 3rd 2001
From The Economist print edition

Istanbul shot up by 18.7%, following the approval of about $10 billion-worth of new loans from the IMF and World Bank. The funds are intended to help Turkey to resolve its financial crisis. Taipei lost 3.8%, as a slowing economy and disappointing first-quarter corporate profits unsettled investors.

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	May 2nd		Dec 31st 2000	
	May 2nd	year ago	May 2nd	% p.a.		one week	in local currency	in $ terms
China	8.28	8.28	11.9	na	2,214.5	+ 0.1	+ 1.0	+ 1.0
Hong Kong	7.80	7.79	11.2	4.20	13,814.2	+ 4.3	– 8.5	– 8.5
India	46.8	43.7	67.4	7.71	3,538.4	– 1.7	– 10.9	– 11.2
Indonesia	11,225	8,000	16,161	16.28	362.7	+ 2.7	– 12.9	– 24.9
Malaysia	3.80	3.80	5.47	3.30	611.4	+ 6.7	– 10.0	– 10.0
Philippines	50.7	41.3	73.0	13.00	1,435.9	– 1.8	– 3.9	– 5.3
Singapore	1.82	1.72	2.61	2.28	1,737.7	+ 4.0	– 9.8	– 13.9
South Korea	1,307	1,110	1,881	5.90	583.7	+ 3.1	+ 15.7	+ 12.0
Taiwan	32.9	30.7	47.3	4.60	5,304.2	– 3.8	+ 11.8	+ 12.6
Thailand	45.5	38.4	65.5	2.50	299.5	+ 0.9	+ 11.3	+ 6.1
Argentina	1.00	1.00	1.43	12.77	433.4	+ 3.0	+ 3.9	+ 4.2
Brazil	2.23	1.82	3.21	16.29	14,898.3	+ 5.2	– 4.5	– 16.4
Chile	603	517	867	3.42*	5,091.7	+ 2.4	+ 4.6	– 0.4
Colombia	2,345	2,018	3,376	12.75	819.3	+ 0.2	+ 14.9	+ 9.6
Mexico	9.28	9.40	13.4	13.25	6,103.1	+ 2.9	+ 8.0	+ 11.8
Peru	3.59	3.48	5.2	14.34	1,205.1	– 0.1	– 0.3	– 1.9
Venezuela	712	676	1,026	12.31	7,520.0	+ 2.1	+ 10.7	+ 8.7
Egypt	3.89	3.44	5.60	9.11	6,274.2	+ 0.5	– 18.1	– 18.1
Israel	4.14	4.09	5.97	5.25	424.3	+ 4.3	– 14.2	– 16.3
South Africa	8.03	6.84	11.6	10.70	8,968.5	+ 1.0	+ 7.7	+ 1.5
Turkey	1,166,500	616,490	1,679,410	73.00	12,008.5	+18.7	+ 27.2	– 26.9
Czech Republic	38.9	40.8	56.0	5.01	414.9	– 1.0	– 13.3	– 16.1
Hungary	300	289	432	11.30	6,959.4	+ 0.3	– 11.3	– 16.5
Poland	3.96	4.49	5.70	17.14	15,234.8	– 1.2	– 14.6	– 10.9
Russia	28.9	28.4	41.6	25.00	180.7†	+ 5.2	+ 27.1	+ 26.1

*Inflation adjusted. †In dollar terms.

Sources: National statistics offices, central banks and stock exchanges; Primark Datastream; EIU; Reuters; Warburg Dillon Read; J.P. Morgan; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Bank Ekspres; Deutsche Bank; *Russian Economic Trends*.

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ECONOMY

May 3rd 2001
From The Economist print edition

Russia's visible-trade surplus narrowed a little to $60.9 billion in the year to March. In the same period Poland's trade deficit shrank to $10.3 billion—a third smaller than it was a year ago. Indonesia's inflation rate was above target in April, at 10.5%. South Korean inflation rose to 5.3%, its highest level since November 1998.

	% change on year earlier			Latest 12 months, $bn		Foreign reserves*, $bn	
	GDP	Industrial production	Consumer prices	Trade balance	Current account	Latest	Year ago
China	+ 8.1 Q1	+12.1 Mar	+ 0.8 Mar‡	+23.7 Mar	+15.7 1999	178.0 Feb	159.5
Hong Kong	+ 6.8 Q4	− 0.2 Q4	− 1.3 Mar	−11.6 Mar	+ 8.8 Q4	114.6 Mar	93.8
India	+ 6.0 Q2	+ 0.6 Feb	+ 3.0 Feb	− 6.7 Feb	− 5.4 Q4	39.5 Mar	35.7
Indonesia	+ 5.2 Q4	+ 4.5 Q4‡	+ 10.5 Apr	+26.9 Mar	+ 5.5 Q3	22.3 Feb	27.6
Malaysia	+ 6.5 Q4	+ 4.3 Feb	+ 1.5 Mar	+15.3 Mar	+ 9.7 Q3	26.8 Mar	33.2
Philippines	+ 3.6 Q4	− 3.0 Feb	+ 6.7 Mar	+ 7.2 Feb	+ 9.3 Dec	12.2 Feb	12.7
Singapore	+ 4.6 Q1	+ 6.4 Mar	+ 1.7 Mar	+ 3.8 Mar	+21.8 Q4	80.2 Feb	74.9
South Korea	+ 4.6 Q4	+ 6.2 Mar	+ 5.3 Apr	+14.0 Mar	+12.8 Mar	94.4 Mar	83.6
Taiwan	+ 4.1 Q4	− 4.4 Mar	+ 0.4 Mar	+10.3 Mar	+ 9.6 Q4	110.1 Feb	113.6
Thailand	+ 3.1 Q4	+ 2.4 Feb	+ 2.6 Apr	+ 3.7 Mar	+ 7.3 Mar	31.7 Mar	31.7
Argentina	− 2.0 Q4	+ 0.5 Mar	− 1.0 Mar	+ 1.5 Feb	− 9.4 Q4	21.9 Mar	24.6
Brazil	+ 4.4 Q4	+ 1.5 Feb	+ 6.3 Mar	− 1.4 Apr	−27.0 Mar	35.1 Feb	37.0
Chile	+ 4.5 Q4	− 1.7 Mar	+ 3.5 Mar	+ 1.1 Mar	− 1.0 Q4	14.5 Mar	14.2
Colombia	+ 2.1 Q4	+ 1.5 Feb	+ 7.8 Mar	+ 1.3 Feb	− 0.1 Q4	9.3 Mar	8.3
Mexico	+ 5.1 Q4	− 3.7 Feb	+ 7.2 Mar	− 8.9 Mar	−17.7 Q4	40.2 Mar	36.4
Peru	− 2.5 Feb	+ 0.2 Jan	+ 3.6 Mar	− 0.4 Feb	− 1.7 Q4	8.2 Feb	9.1
Venezuela	+ 5.6 Q4	na	+ 12.1 Apr	+ 7.2 Nov	+13.4 Q4	12.9 Mar	11.4
Egypt	+ 6.5 2000†	+ 9.4 2000†	+ 2.6 Jan	−10.4 Q4	− 0.8 Q4	12.9 Jan	14.0
Israel	+ 3.0 Q4	+10.7 Jan	+ 0.7 Mar	− 7.2 Mar	− 0.7 Q3	23.9 Mar	22.8
South Africa	+ 3.3 Q4	+ 1.6 Feb	+ 7.4 Mar	+ 3.6 Mar	− 0.5 Q4	6.2 Feb	6.4
Turkey	+ 8.3 Q4	− 5.2 Feb	+ 37.5 Mar	−27.0 Feb	−10.2 Jan	18.6 Mar	23.1
Czech Republic	+ 3.9 Q4	+ 6.5 Feb	+ 4.1 Mar	− 3.5 Mar	− 2.3 Q4	12.8 Mar	12.6
Hungary	+ 4.2 Q4	+18.5 Feb	+ 10.5 Mar	− 2.4 Mar	− 1.7 Mar	10.7 Mar	10.7
Poland	+ 2.4 Q4	+ 2.8 Mar	+ 6.2 Mar	−10.3 Mar	− 9.0 Mar	27.1 Mar	25.3
Russia	+ 7.7 2000	+ 3.6 Mar	+ 23.8 Mar	+60.9 Mar	+46.4 Q4	25.9 Mar	11.5
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*						
Pakistan	+ 3.9 1999†	+ 7.9 Oct	+ 4.2 Mar	− 1.9 Jan	− 2.5 1999	1.1 Jan	1.6
Saudi Arabia	+ 0.4 1999	na	− 1.3 Dec	+24.9 1999	+ 0.4 1999	17.1 Jan	16.2

*Excluding gold, except Singapore; IMF definition. †Year ending June. ‡New series.

Text refers only to the first 25 countries listed

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